

25 February 2011

Dr. Richard Sandlant
 Future of Financial Advice
 Department of treasury
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Email: futureofadvice@treasury.gov.au

Dear Dr. Sandlant,

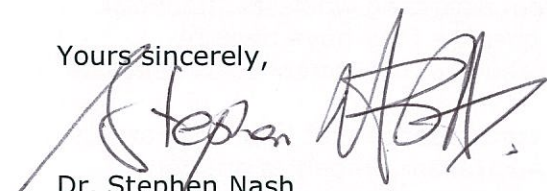
Re: Wholesale and Retail Clients Future of Financial Advice, Options Paper, January 2011

I refer to the request for feedback and comments made in the above paper.

As the organisation with one of the largest fixed income sales forces in Australia, FIIG is well placed to provide advice on this important paper, especially as it relates to the market for direct fixed income in this country. FIIG has the dominant position in Australia for providing access to direct holdings of fixed income, with a client base that is much broader than almost all other fixed income brokers in Australia. As a result the topics covered in the above paper are of importance to both FIIG and the clients that we serve on a daily basis.

Accordingly, please find enclosed a submission of comments for your information. FIIG would be more than interested in discussing this submission with you at some time in the future.

Yours sincerely,



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Wholesale and Retail Clients Future of Financial Advice Options Paper: Submissions

Option 1: Retain and update the current system

7.4 Update the Product Thresholds

Questions:

- *Is an arbitrary but objective test preferable to a subjective test which more accurately reflects the individual circumstances of the client?*

FIIG's response

- While objective tests are easier to administer and appropriate in a general sense, there will be circumstances where a financially literate investor may not be able to be classified as a wholesale client. Therefore, subjective tests that more accurately reflect the individual circumstances of the client should be an option.
- *Should all 3 thresholds be updated (that is, the product value test and the two tests based on personal wealth in s761G(7)(c)), or just the \$500,000 product value threshold?*

FIIG's response

- The basis for increasing any of the thresholds of the three tests is highly questionable.
- A decision to increase the thresholds ought to be based upon a proper analysis. For example, under the current thresholds, what proportion of the population satisfies one of the three thresholds? Anecdotally, the percentage would be very small. On the basis that that percentage is small, what is the benefit of making that percentage smaller? In other words, is it really delivering protection to investors who are actually retail clients or is it making it more difficult for financially literate investors from accessing wholesale financial products (including investment grade wholesale bonds) because they have been re-categorized as from wholesale clients to retail clients because of the increased thresholds?
- Increasing the thresholds will also have the unintended consequence that lower risk assets such as investment grade bonds issued by high quality Australian companies are only issued to wholesale clients thereby preventing retail clients from accessing lower risk financial investments, or investing in a diversified portfolio of these lower risk assets, or both.
- A consequence of increasing the product value threshold is that the level of that threshold will determine the minimum price set by issuers of financial products for those products. For example \$500,000 is the current minimum price at which financial products are issued for wholesale issues. This includes investment grade bonds issued by well known Australian companies. This results in the detrimental consequence of acting as an impediment to diversification (e.g., under the current thresholds if an investor is investing \$1 million, he or she can only invest in two products of \$500,000 each).
- It also acts as an impediment to investing in lower risk assets (such as wholesale investment grade bonds). People do not buy \$500,000 parcels of bonds. As a result investors are channeled towards higher risk investments such as equities and fixed income proxies such as listed and unlisted property trusts.
- This impediment to diversification could be assisted through broadening what a 'class of security' constitutes when aggregating the values of investments to satisfy the product value test... For example, currently a transaction to purchase \$500,000 of one bond by one issuer is wholesale. However purchasing five bonds of similar quality of \$100,000 each from five similar quality issuers is considered retail. If the five individual bonds were

considered to be the same 'class' then this would assist with diversification for that investor.

- Therefore, increasing the product value test from \$500,000 to a higher amount simply exacerbates these impediments and results in the opposite of what it is intended to achieve, namely protection for retail clients because it results in these retail clients directing investments into higher risk alternatives such as equities and fixed income proxies such as property trusts.
- In addition, current thresholds also force many issuers into the banking system when they are sourcing debt capital when they could be connecting directly with investors through high quality debt issues, which are relatively cheap to execute for the issuer, thereby allowing the issuer to diversify and creates competition for the major banks. Raising thresholds and forcing issuers back to full prospectus issues, in the event they need to execute a retail transaction, is not an optimal situation, even given CP126. In other words, the current thresholds are not only distorting the investment landscape, they are distorting the capital markets by herding issuers into the banking system to source debt capital, when a more cost effective issuance mechanism would allow more flexibility to issuers. Again, increasing these thresholds will make matters worse.
- *Is \$1,000,000 an appropriate new threshold limit for the product value test?*

FIIG's response

- No.
- \$1,000,000 is an arbitrarily high value for a product value test with unintended detrimental consequences for investors as they can only invest in a single or few large tranches rather than diversifying into a number of investments. Therefore, an increase in the threshold of this size will discourage diversification and this would increase the risk profile of these portfolios.
- Consideration needs to be given to extending the product value test to a class of investments. For example, currently, an investor can invest \$500,000 in one product and be treated as a wholesale client but can't invest \$100,000 in 5 investments, or \$50,000 in 10 investments, of the same class. Therefore, the current test impedes prudent diversification into the portfolio of assets of the same class. For example, currently a "class" is limited to effectively the same product so that different investment grade bonds issued by the same company or a number of companies do not constitute the same class.
- *Is information available on how many investors would meet the proposed new limit for their products?*

FIIG's response

- No.
- But it can be safely assumed that currently only a very small percentage of the population can invest in a financial product for a price of \$500,000 each. So increasing the limit to \$1,000,000 to reduce that percentage to a smaller amount appears to be questionable.

Is there any specific reason why regulation 7.1.22 should not be amended to more accurately reflect the investment a client actually makes in a derivative?

FIIG's response

- No comment. FIIG does not deal in derivatives.

7.5 Introduce an indexing mechanism

Questions:

- *How could a simple and relevant indexing mechanism be introduced? – An example of a simple mechanism may be to assume a certain percentage growth per annum and legislate that the thresholds must be updated to a round number based on that growth rate with effect every 5 years.*

FIIG's response

- The suggested method could be implemented in a practical sense. But its utility is questionable.
- Rather, periodic reviews every five years may be more appropriate.
- *Will three different threshold limits and constant indexing be too difficult or confusing to implement?*

FIIG's response

- Yes.
- Three different threshold limits and constant indexing would be too difficult and confusing to implement particularly over a long period of time.
- Thresholds need to be simple and easy to remember and implement by product issuers, providers of financial products and services and investors in order to provide certainty.
- *What value should be used as the basis for indexing?*

FIIG's response

- If indexing is used, CPI is the most appropriate.
- *How often should the 3 limits be indexed?*

FIIG's response

- If indexing is adopted, every five years could be appropriate.

7.6 Exclude Illiquid Assets

Questions:

- *Are there any reasons why a primary residence should/should not be included in the net assets test?*

FIIG's response

- The primary residence should be included in the net assets test.
- Otherwise, it would mean that investors with a primary residence are disadvantaged when compared to investors without a primary residence.
- Excluding the primary residence could influence people to sell their primary residence in order to satisfy the net assets test.

- *Are there any specific reasons why superannuation should/should not be included in the net assets test?*

FIIG's response

- Superannuation should be included in the net assets test.
- Many experienced investors structure some or all of their investments and assets through a SMSF.
- These investors would be at a disadvantage if these assets were excluded from the asset test.
- *Would excluding some assets cause too much difficulty or confusion for industry? Which assets?*

FIIG's response

- Yes.
- It would be very hard to exclude some assets from the test.
- It would be inequitable for people who have chosen to invest in different asset classes.
- What is required is as simple a qualifying test as possible and excluding some assets adds to the complexity and confusion.
- *Would this work prohibitively to exclude clients who should be classified as wholesale?*

FIIG's response

- Yes.
- Experienced investors would be excluded unnecessarily.
- All assets in all structures should be considered including primary residence, SMSF, companies and trusts

7.7 Amend the Deeming Process

Questions:

- *Would an explicit opt-in make investors sufficiently aware of what protections they are afforded?*

FIIG Response

- This would increase awareness but not necessarily their understanding depending on what they were advised.
- *Would an explicit opt-in be prohibitively inefficient for industry? – What would be a more appropriate test for investor opt-in?*

FIIG Response

- An explicit opt-in would require more paperwork and would be costly to administer.
- Institutions may choose not to sell products if a client has opted out of being a wholesale client. This could end up reducing the number and type of investments offered to clients.

- *Would the true policy objective and message be easy to avoid via standard forms?*

FIIG Response

- No.
- *Should investors be able to elect to be treated as a retail client even when they meet the wholesale wealth threshold tests?*

FIIG Response

- No.
- Wholesale investors should not be able to be treated as retail. This places added risk on institutions to give retail protection to what is clearly a wholesale investor.
- Retail protection is in place to protect those that don't have the capacity to help themselves. It would not be fair to anyone to offer this same protection to wholesale clients.
- If a client decides to be treated as retail, then there will be reduced product available to them.

7.8 Two out of Three Requirements

Questions:

- *Are there any specific reasons why meeting 1 out of 3 requirements is better than meeting 2 out of the 3 (or vice versa)?*

FIIG's response

- There is little benefit in investors meeting more than one requirement. It simply imposes an added restriction on investors who are currently wholesale clients from investing in a diversified portfolio of quality wholesale assets.
- More guidance on 'class of security' when using the \$500,000 product volume test would be useful as the current test rule is preventing diversification by many investors. A better definition of 'class' may assist with this.
- *Is meeting 2 of the 3 requirements likely to be a better proxy for financial literacy than the current test?*

FIIG's response

- No.
- Conversely, meeting two out of three tests would be detrimental to a number of investors. For example, a non working investor who has more than \$2,500,000 in net assets would be prevented from being treated as a wholesale client. This will reduce their ability to invest in wholesale financial product appropriate to them and to diversify their portfolios.
- This would create problems when combining a product value test with the income/asset test. To satisfy this, all wholesale clients would need to satisfy either the income or asset test if combining with a product value test. This would be difficult to administer for the issuers who rely solely in the product value test.

- *Would this requirement be prohibitive for investors who wish to be classed as wholesale?*

FIIG's response

- Yes.
- This requirement would be prohibitive for some investors. They may not meet the two out of three test requirement when they previously satisfied one of the tests.

7.9 Introduce extra requirements for certain complex products

Questions:

- *What are the complex products that the higher threshold should apply to?*

FIIG's response

- Derivatives
- Complex structured products
- *What is the higher threshold that should apply to these products?*

FIIG's response

- No higher thresholds recommended.
- The existing thresholds are adequate.

7.10 Repeal the 'Sophisticated Investor' Test

Questions:

- *Should investors with less wealth but high financial literacy have some way of accessing wholesale products? – If yes, how might this be operationalised in an objective manner?*

FIIG's response

- Yes.
- Develop a training course or accreditation that investors can complete (analogous to RG146 for people who provide financial advice).
- *Given that industry favours objective tests over subjective tests, is this a strong enough reason to repeal the section entirely?*

FIIG's response

- No – why remove flexibility to those that do use it?
- *Should the section be retained even if it is scarcely used?*

FIIG's response

- Yes – see above.

Option 2: Remove the distinction between wholesale and retail clients

Questions:

- *Would the financial advice industry be willing to undertake a suitability and best interests verification for each retail client that personal advice is provided to under the retail client definition proposed in this option?*

FIIG's response

- FIIG does not provide personal financial product advice to retail clients but it doubts that such a verification would work or achieve its aims. It may result in less advice being made available to retail clients.

Is the loss in efficiency offset by greater investor protection?

FIIG's response

- No.
- Treating all clients as retail will create a significant administration burden for dealing with wholesale investors who will not benefit from disclosures.
- Applying retail disclosure to all clients will reduce the product offerings available in the market place.

Is it appropriate to remove the distinction from the entire Act?

FIIG's response

- No.
- Classifying all investors as retail would result in many products being removed from the market because of the onerous disclosure obligations.

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

- *Is the test under section 761GA a true indication of financial literacy?*

FIIG response

- Not necessarily.
- *Is there any way that section 761GA can be amended to allay fears of licensees being exposed to legal liability while maintaining investor protection?*

FIIG response

- Not as it is currently framed.
- If investors completed a qualification or accreditation (analogous to RG146) then that could be an appropriate one to illustrate that an investors is a wholesale client.
- *Is it possible for a subjective test to be easy to administer and ensure that intermediaries are not unduly cautious?*

FIIG response

- Not as it is currently framed in section 761GA of the Act.

Option 4 – Do Nothing

Questions:

- *Is there any reason why the current tests should be retained in the face of problems experienced during the GFC?*

FIIG's response

- Yes.
- There doesn't appear to be any empirical evidence to support any of the proposed changes or increases to the thresholds.
- Conversely, the changes would have unintended detrimental consequences to investors as discussed above particularly those who are currently wholesale clients under the current thresholds or those who would fall into that category in the future.
- *Are the monetary threshold limits still relevant?*

FIIG's response

- Yes.
- But increasing the thresholds is highly questionable as discussed above.
- *Should they be increased? If so, by how much?*

FIIG's response

- No.

