FINANCIAL OMBUDSMAN SERVICE

Wholesale and retail clients
Submission in response to options paper

This is the submission by the Financial Ombudsman Service ("FOS") in response to the Options Paper released by Treasury in January 2011 *Wholesale and Retail Clients – Future of Financial Advice*.

This submission draws on the experience of FOS and its predecessors in the resolution of disputes relating to financial services. The submission has been prepared by the office of FOS and does not necessarily represent the views of the Board of FOS.

Information about FOS

FOS commenced operations on 1 July 2008. It is an independent dispute resolution scheme that was formed through the consolidation of three schemes:

- the Banking and Financial Services Ombudsman ("BFSO");
- the Financial Industry Complaints Service ("FICS"); and
- the Insurance Ombudsman Service ("IOS").

On 1 January 2009, two other schemes joined FOS, namely:

- the Credit Union Dispute Resolution Centre ("CUDRC"); and
- Insurance Brokers Disputes Ltd ("IBD").

FOS is an external dispute resolution ("EDR") scheme approved by ASIC. Membership of FOS is open to any financial services provider carrying on business in Australia including providers not required to join a dispute resolution scheme approved by ASIC. Replacing the schemes previously operated by BFSO, FICS, IOS, CUDRC and IBD, FOS provides free, fair and accessible dispute resolution for consumers unable to resolve disputes with financial services providers that are members of FOS.

Members of BFSO, FICS, IOS, CUDRC and IBD are now members of FOS. The members of those schemes included:

- BFSO – credit providers, mortgage brokers, payment system operators, Australian banks and their related corporations, Australian subsidiaries of foreign banks and foreign banks with Australian operations;
- FICS – life insurance companies, fund managers, friendly societies, stockbrokers, financial planners, pooled superannuation trusts, timeshare operators and other Australian financial services providers;
- IOS – general insurance companies, re-insurers, underwriting agents and related entities of member companies;
- CUDRC – credit unions and building societies;
- IBD – insurance brokers, underwriting agents and other insurance intermediaries.

FOS has over 20 years' experience in providing dispute resolution services in the financial services sector and it is estimated that FOS covers up to 80% of banking, insurance and investment disputes in Australia.

FOS provides services to resolve disputes between member financial services providers and consumers, including certain small businesses, about financial services such as:

- banking;
- credit;
- loans;
- general insurance;
- life insurance;
- financial planning;
- investments;
- stock broking;
- managed funds; and
- pooled superannuation trusts.

As well as its functions in relation to dispute resolution, FOS has responsibilities to identify and resolve systemic issues and obligations to make certain reports to ASIC.

FOS is a not for profit organisation funded by its members, which are financial services providers. It is governed by an independent board with consumer representatives and financial services industry representatives.

Summary of feedback and comments

For the reasons outlined below, we consider Option 4 unsatisfactory and do not think that Option 2 is warranted. We believe that the *Corporations Act 2001* should continue to distinguish retail clients from wholesale clients, but the tests to distinguish the two categories should be changed.

The discussion of Option 3 in the Options Paper explains that investors with lower financial literacy have a greater need for the consumer protections provided under the Corporations Act than more financially literate investors. We agree with this analysis, which supports the view that the test to distinguish retail clients from wholesale clients should be a direct test of financial literacy.

Through our dispute resolution work, we have seen cases in which:

- investors in financial services who were not financially literate were classed as wholesale clients under the objective test in section 761G; and
- investors classed as wholesale clients did not understand the ramifications of that classification.

If the objective test in section 761G, or a modified form of it, continues to apply, we suggest that measures be introduced to ensure that an investor may only be classed as a wholesale client if they elect to be classed in that way after receiving a written warning, in clear terms, of the ramifications of that classification. It may be possible to use the Italian approach described in footnote 28 in the Options Paper as a model for the measures suggested.

If the subjective test in section 761GA, or a modified form of it, continues to apply, we think consideration should be given to introducing measures of the type suggested above in place of the existing safeguards in section 761GA(f). In our assessment, these measures would improve consumer protection and may, as explained below, allow section 761GA to operate more satisfactorily.

Feedback and comments

Answers to consultation questions and comments on options set out in the Options Paper are provided below. We are not in a position to answer some consultation questions. To avoid restating sections of the Options Paper, this submission does not refer to our comments where the Options Paper contains those, or similar, comments.

Option 1 – Retain and update the current system

Proposal 7.4 – Update the product thresholds

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

  We have considered disputes in which investors with very low financial literacy were classed as wholesale clients under the objective test in section 761G and invested in complex financial products without receiving the protection given to

retail clients under the Corporations Act. In cases of this type, we believe that the objective test produces unsatisfactory results because it does not directly test financial literacy.

- 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?

  Increases to the thresholds would be expected to reduce the proportion of investors classed as wholesale clients. As the objective test does not directly test financial literacy, however, the increases would not prevent investors with low financial literacy from being classed as wholesale clients and therefore not receiving the protection given to retail clients.

  We have considered disputes in which the investor has had considerable wealth, but low financial literacy. This is sometimes the position where the investor acquired their wealth through inheritance from a deceased relation who previously handled all of the family's financial matters.

Proposal 7.5 – Introduce an indexing mechanism

The Options Paper notes arguments against proposal 7.5 that we consider to be persuasive. Indexing would add a further level of complexity and, at best, would merely update tests that are arbitrary.

Proposal 7.6 – Exclude illiquid assets

When considering disputes, we have come across cases in which investors with low financial literacy satisfied the net asset wealth threshold test. In many of these cases, the investor would not have satisfied the test if illiquid assets had been excluded from the calculation of assets. This suggests that proposal 7.6 could be used to reduce the proportion of investors with low financial literacy classed as wholesale clients under the objective test.

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

  We note that regulation 7.1.26 excludes certain superannuation sourced money from the product threshold test. Taking a similar approach in the net assets test would promote consistency.

Proposal 7.7 – Amend the deeming process

On page 18, the Options Paper indicates that some investors are deemed to be wholesale clients under the current legislation without their knowledge or consent. As noted under "Summary of feedback and comments" above, we have seen cases

in which investors classed as wholesale clients did not understand the ramifications of that classification. We believe that these issues should be addressed and that proposal 7.7 could be used to address the issues.

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

  The Italian mechanism described in footnote 28 in the Options Paper provides a model of an opt in procedure that could be used to make investors aware of the protection given to retail clients. It may be possible to develop a streamlined version of the mechanism that is less onerous for industry.

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

  It may be necessary to require information provided to investors under an opt in procedure to meet specified standards. There could, for example, be general requirements for the information to be clear and concise and to give prominence to crucial details. An alternative would be to prescribe contents of key messages.

- Should investors be able to elect to be treated as a retail client even when they meet the wholesale wealth threshold tests?

  If an investor classed as a wholesale client does not want to be classed in that way, but cannot elect to be treated as a retail client, their choice will be to proceed with investments as a wholesale client or miss investment opportunities. Neither option is attractive and we do not think that investors should be put in that position. Some investors in that position may feel that they have to proceed as wholesale clients, or, in other words, that they have no real choice. So we consider that investors classed as wholesale clients should be able to elect to be treated as retail clients.

Proposal 7.8 – Two out of three requirements

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

  Proposal 7.8 could be used to reduce the proportion of investors classed as wholesale clients under the objective test.

Proposal 7.9 – Introduce extra requirements for certain complex products

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

In disputes that we have considered, investors have had particular difficulty understanding the risks associated with the following products and strategies:

- over-the-counter and exchange traded contracts for difference;
- binary options;
- collateralised debt obligations;
- futures;
- exchange traded options;
- securities lending;
- short selling of securities; and
- warrants.

- What is the higher threshold that should apply to these products?

  The disadvantages of arbitrary tests are noted in the Options Paper. An alternative to setting another threshold would be to impose different requirements in respect of complex products. For example, investments in complex products could be permitted only by investors who demonstrate that they satisfy the sophisticated investor test under section 761GA or some other test of financial literacy.

Proposal 7.10 – Repeal the "sophisticated investor" test

- 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?

  As previously explained, we believe it is appropriate for investors with high financial literacy to be classed as wholesale clients. At present, wholesale clients can take advantage of opportunities not provided to retail clients, such as lower price arrangements.

  There are some indicators of financial literacy that could be used to create an objective sophisticated investor test. Such a test could, for example, require an investor to have a certain combination of qualifications and experience relevant to investment. The definition of "professional investor" in section 9 creates an objective test. Perhaps this could form a model for an objective sophisticated investor test.

Option 2 – Remove the distinction between wholesale and retail clients

Removing the distinction between wholesale and retail clients could have a very significant impact on the regulation of financial services. The retail client concept is

central to many provisions in the Corporations Act and associated regulatory documents. The Options Paper does not suggest that Option 2 involves introducing a replacement concept in these provisions and we assume this is not proposed.

Section 912B is one example of the Corporations Act provisions that impose requirements to protect retail clients. It requires holders of Australian Financial Services Licences to have arrangements for compensating retail clients for losses they may suffer due to breaches of the licensee's obligations under Chapter 7 of the Corporations Act. The Options Paper does not discuss the advantages and disadvantages of altering specific requirements to protect retail clients imposed by provisions such as section 912B.

There are many examples of EDR requirements under the Corporations Act that hinge on the retail client concept. These requirements are particularly important to FOS and other EDR schemes approved by ASIC under its Regulatory Guide 139 *Approval and oversight of external dispute resolution schemes*. Sections 912A(2) and 1017G(2) require certain financial services providers to be members of ASIC approved EDR schemes that cover complaints made by retail clients. To maintain approval under ASIC's Regulatory Guide, EDR schemes have to meet obligations that refer to retail clients as defined in the Corporations Act. For example, the schemes have to:

- ensure that retail clients can access their services; and
- be able to consider disputes involving monetary amounts of up to $500,000, which is set by reference to the product threshold in section 761G.

It appears to us that Option 2 could not be implemented without first undertaking a major review of regulatory arrangements for financial services, to ascertain what impact the option would have. We do not believe that such a review is warranted to achieve the advantages specified on page 22 of the Options Paper and therefore do not believe that Option 2 is warranted.

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

For reasons noted above, we consider that the Corporations Act should distinguish retail clients from wholesale clients by means of a direct test of financial literacy. Such a test could be developed by modifying the sophisticated investor test in section 761GA.

In our view, the current sophisticated investor test is not easy to apply. We also note that submissions made by financial services providers in disputes that we have considered raise doubts as to whether licensees understand what the sophisticated investor test is designed to test – which is particular experience relevant to the

investment contemplated. For example, financial services providers have argued in disputes that:

- because investors were experienced business people, accountants or lawyers, they should be taken to have understood the risks of investments; and
- based on their experience in investing in listed shares, investors were aware of the risks of more complex products such as uncovered options or contracts for difference.

Section 761GA may operate more satisfactorily if it incorporates an opt in procedure of the kind contemplated in proposal 7.7. Instead of signing the written acknowledgement in accordance with section 761GA(f), the investor could opt in to being classed as a wholesale client. This change would, in our view, make the licensee's application of the sophisticated investor test a less crucial factor. An investor would only be classed as a wholesale client if they opt in.

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

  The test under section 761A focuses on previous experience. It may more accurately test financial literacy if it also recognises knowledge that allows an investor to assess the matters specified in section 761GA(d)(i) to (v). This could include, for example, knowledge acquired through academic study.

Option 4 – Do nothing

We consider Option 4 unsatisfactory. The deficiencies of the current arrangements identified in the Options Paper and noted in this submission have had serious adverse consequences within the financial services industry and, if not addressed, may continue to have those consequences.

Further considerations

We think that it would be helpful to clarify the meaning of the phrase "relates to a superannuation product" in section 761G(6)(b) and (c).