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Future of Financial Advice
Department of Treasury
Langton Crescent
CANBERRA ACT 2600
ATTENTION Dr Richard Sandlant

Dear Sirs

Wholesale and Retail Clients Future of Financial Advice

Henry Davis York is grateful for the opportunity to comment on the options paper, Wholesale and Retail Clients Future of Financial Advice, dated 24 January 2011. Our submission is set out in the attachment to this letter.

We would be happy to elaborate on our comments if that would be of further assistance.

Yours faithfully
Henry Davis York

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Wholesale and Retail Clients: Future of Financial Advice

Submission on Options Paper

1 Background

The options paper "Wholesale and Retail Clients Future of Financial Advice" released by Minister Shorten on 24 January 2011 (**Options Paper**), considers the options for refining the legislative distinction between wholesale and retail clients. It takes advantage of international research, and poses questions and options for further consideration.

A number of obligations of financial product issuers and financial advisers hinge on the definitions of wholesale and retail clients, which serve, in summary, to distinguish between those able to fend for themselves in purchasing financial products and those in need of enhanced regulatory protection.

We act for many participants in the financial services industry including wholesale funds, Australian superannuation trustees, overseas operators looking to invest in Australia as well as Australian retail and wholesale product issuers.

This submission addresses some of the questions raised and the options presented which are more relevant to the range of clients that we deal with. In particular, we support the refinement of the definitions of wholesale and retail clients to reflect more accurately the classification of a client and their level of expertise. However we believe caution is warranted against amendments that would unduly impede the market for financial products and the development of a more internationally focussed Australian financial services centre.

2 Submissions on Options

In our view, the challenge in changing the retail/wholesale distinction is to ensure that wholesale clients are adequately defined as those that have the financial expertise to perform appropriate due diligence on financial products prior to issue or sale, including understanding the risk and impact of financial losses.

Such financial expertise should extend to an appreciation of matters such as the remedies available against the issuer or seller, in the event of a dispute over the terms of the product - including in the event of the provider's insolvency.

In coming to a judgement about the possession of such expertise, it is appropriate to recognise the impact of over-regulation. The potential concerns here are that:

- product providers will be deterred by increased regulation from offering products in the Australian market - either on a large scale, or at all; and

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- clients who understand complex products and have the resources to negotiate their terms and pursue their own remedies, are denied the opportunity to invest.

It remains important to recognise the international impact of changing the Australian regime. A financial services provider regulated by an approved overseas regulatory authority may, in certain circumstances, provide financial services to wholesale clients in Australia without requiring to be locally licensed.[1] As a result, important European, United States and Asian product and service providers stand to be affected by any change in scope of the definition. This could impact upon initiatives to develop Australia as a hub for financial services within the region in two ways:

- by impacting upon the pool of local clients forming the market for international products and services; and

- by affecting perceptions of the commitment to developing a more international market in Australia and a simpler regulatory regime for international investment.

The Options Paper puts forward four options to change the current system for distinguishing between wholesale and retail clients.

(a) **Option 1 - Retain and update the current system**

This option assumes that the current system is generally effective but has become outdated. It also suggests that if the objective tests in the current system are modernised, then there would be less need for the subjective sophisticated client test, which could be removed. The proposals put forward for discussion include lifting the monetary thresholds for wholesale financial products to $1,000,000 with indexing, and excluding illiquid assets (e.g. the family home) from being counted in the net asset wealth threshold.

Many of the aspects of the definition of a wholesale client use wealth as a proxy for expertise in financial products. However, in some cases it cannot be assumed that wealthy individuals possess a sufficient level of financial understanding of the products they are investing in, or the risks associated with that investment. And as we saw in the case of the local governments, this is not always the case.[2] The current monetary thresholds may be too low given changes in asset prices over recent years in Australia and the opportunities for individuals to acquire large amounts of assets relatively quickly.

It has been proposed that regulation could also introduce objective tests based on the type of product being invested in. ASIC has been exploring differing levels of disclosure requirements for "complex" and "simple" products for some time now. However, drawing the boundaries around the definition of a "complex" product is proving to be difficult. In the context of the shorter PDS regulation being developed at the moment there is currently a debate about whether using a liquidity test to determine the level of complexity of the product is the right approach.

[1] See ASIC Regulatory Guide RG 176.
[2] See also *JP Morgan Chase Bank v Springwell Navigation Corporation* [2008] EWHC 1186 (Comm).

That said, the monetary thresholds are at least objective, certain and consistent with the approach of international regulation.

In our view the thresholds for product value and personal wealth under sections 761G(7)(a) and (c) ought to be updated to ensure that they more accurately distinguish wholesale clients from retail clients. Indexing of the thresholds should be resisted for reasons of complexity. Furthermore regulation 7.1.22 of the Corporations Regulations should be amended so that it more accurately reflects the value of a derivative for section 761G(7)(a).

However, in our view the case has not been made out for other approaches suggested in Option 1. In particular we are not convinced that a more protective regime is merited for products (notably derivatives) nominally more complex than others. Such an approach is already taken in relation to widely-marketed insurance and superannuation products. However such products supply domestic insurance benefits whose actuarial complexity is matched by their widespread use. This is not the case for derivative products, which are not products of everyday application for households, and ought not to be regulated as such.

Beyond further regulation, we believe more time should be devoted to educating clients. The financial services industry as a whole would benefit from clients making better informed investment decisions, more than from ever-increasing client protection, which adds to product issuers' compliance obligations and potential liabilities. However, we are conscious that increasing the financial understanding of clients is a long term solution, so this approach alone is not enough.

(b) **Option 2 - Remove the distinction between wholesale and retail clients**

Shortly put: this is not a realistic option for the industry in view of the high cost of its regulatory burden, and its inconsistency with overseas approaches. As we note above, any reforms must have regard to international impacts of the changes. This option - in addition to being unduly expensive - does not meet this requirement.

This option also proceeds on the basis that the existing disclosure regime for retail clients under the Corporations Act is essentially an effective one. Effectiveness of disclosure documents has been part of industry discussion for the past 2 years.

There are currently a range of initiatives in the industry focussing on the effectiveness of disclosure. For example, ASIC has identified debentures, unlisted property and mortgage funds and over-the-counter CFDs as needing enhanced disclosure. In other words, more detailed information should be provided about complex products. In contrast, the new shorter PDS regime involves less information up front and a greater reliance on incorporation of information by reference: that is, more concise information about simpler products.

While these initiatives and developments lie outside the scope of these submissions, they do need to be considered hand in hand with the breadth of the wholesale/retail definition. For example, the outcome of more clients receiving more information is not necessarily a good one from the client's point of view if that information is not effective and if the client does not understand it. Nor is it beneficial from an issuer's point of view, if it raises compliance costs, which ultimately affect the performance of their products.

(c) **Option 3 - Introduce a "sophisticated investor" test as the sole way to distinguish between retail and wholesale clients**

This option would provide flexibility in approach and allow product issuers to assess clients on a case-by-case basis. The additional compliance burden and associated costs for issuers would be significant, however, and the potential for conflicts of interest is obvious. It does not resolve the liability risks which already make licensees loathe to use section 761GA of the Corporations Act.

As the sole basis for distinguishing between wholesale and retail clients, this option is not realistic.

However, in our view, given the attractiveness of a direct and accurate approach to defining sophisticated clients, it is worth considering whether another entity or agency could take on the role of evaluating the expertise of clients for the purposes of a "supplementary" test of this nature, similar to current section 761GA.

In this regard it is worth noting that licensees do not issue credit ratings for their own products nor do they set the minimum training standards of their advisers.[3] Likewise, it may not be feasible for some licensees to test the expertise of their own clients. Thus, there is merit in considering whether the so-called "subjective" test could be made more effective by transferring the certification role from licensees to more specialised providers or agencies.

(d) **Option 4 - Do nothing**

The current regulation blends the objective tests with the subjective sophisticated client test. This system works relatively well, but we should always be on the lookout to improve and enhance our regulatory regime. For this reason, we are not in favour of the "do nothing" approach.

3 Considering "relates to a superannuation product" and QFS 150

One specific issue addressed in section 8 of the Options Paper involves the interpretation of the words "in relation to a superannuation product" in section 761G of the Corporations Act.

In November 2004 ASIC issued a statement (**QFS 150**) on the application of the retail/wholesale distinction to financial services provided to superannuation

[3] See ASIC Media Release 09-224, and Regulatory Guide RG146.

trustees, that continues to sow confusion, and to frustrate licensees and clients alike.

In QFS 150 ASIC asserts, by way of an interpretation of section 761G(6) of the Corporations Act, that superannuation trustees will in many cases be retail clients, regardless of the nature of the financial services offered to them and whether or not they satisfy the wholesale client tests set out in sub-section 761G(7).

This is said to be because any financial service offered to them "relates to a superannuation product" merely by virtue of the trustee itself operating a superannuation fund. Subsection 761G(7) does not apply where a financial service relates to a superannuation product.

Financial services that authentically relate to a superannuation product are generally governed by the retail client regime, and appropriately so.

For example, advice to a person to become a member of a superannuation fund, or advice to a member to contribute more to the product, is properly treated as a retail financial service.

It does not follow that a financial service provided to a superannuation trustee relates to a superannuation product solely because the recipient of <u>the financial service itself</u> happens to be the issuer of superannuation products. For example, advice to a superannuation trustee to invest in a managed investment scheme is not advice that relates to a superannuation product.

The proposition that a financial service provided to a superannuation trustee inherently relates to a superannuation product within the meaning of the legislation can be seen to be in error:

(a) from the language of section 761G(6). In particular, paragraph 761G(6)(c) begins in the conditional mood, as follows "if a financial service…provided to a person who is (i) the trustee of a superannuation fund…relates to a superannuation product…". The dependent clause of the sentence then follows. Were the relationship between financial services and superannuation trustees automatic, as is suggested by ASIC, the use of the conditional here would be unnecessary.

(b) from the language of section 761G(5). The subsection defines the types of financial service in relation to a general insurance product that constitute provision to a retail client, in terms that specify a number of different types of general insurance product. There is no suggestion that merely being a provider of general insurance products might satisfy the relationship.

(c) from the contradiction ASIC's view creates between sections 761G(5) and 761G(6). In particular, if a financial service in relation to a general insurance policy (e.g. advice as to insuring fine art assets kept in storage, or insurance of trauma of fund members) is provided to a superannuation trustee, section 761G(5) results in the service being provided in relation to a wholesale client. ASIC's interpretation of section 761G(6) provides otherwise. The contradiction cannot be resolved pursuant to the "tie-breaker" provision at section 761G(11), which also has the effect of rendering that provision in important respects incoherent.

(d) from the fact that section 761G(6)(b) and (c) have quite sensible and circumscribed application to circumstances where advice in relation to an interest in a pooled superannuation trust is provided to the trustee of a superannuation fund.

On the basis of these criticisms, we believe QFS 150 should be withdrawn

4 Conclusions

- Revisiting the wholesale and retail client distinction is arguably overdue. However, it is worth reflecting on the broader regulatory objective so that the outcome is not merely an increase in the number of clients who are classified as "retail" simply by operation of the monetary threshold.

    - The greater the number of retail clients, the greater the compliance and disclosure burden on product issuers and other financial services providers.

    - Such consequences are also likely to have an impact on the international appeal of the Australian financial services market.

- In our view, however, there is merit in a one-off adjustment of the thresholds applicable to setting the value of assets qualifying a client as wholesale, and the value of personal wealth serving the same purpose to bring these up to date. In addition, the regulation defining the asset value of derivatives for this purpose should be revisited.

- We are not however in favour of extending protective regimes beyond general insurance and superannuation to other types of products that are not in widespread use amongst Australian consumers. We advocate instead efforts to provide more effective disclosure and to increase client education.

- We are also of the view that a supplementary "subjective" test might be made more workable by transferring the function of certifying a client as an "expert" from licensees to more specialised assessors of such expertise.

- We have also commented in this submission on a particular issue in section 761G and the interpretation of the words "relates to a superannuation product" in ASIC QFS 150. In our view, the ASIC interpretation is not supported by the wording of the section, and as such ASIC QFS 150 should be withdrawn. If the ASIC interpretation is the interpretation supported by government, a change to legislation should be made.

In conclusion, we are grateful for the opportunity to respond to the Options Paper and would be happy to answer any questions on this submission.

Henry Davis York
2 March 2011

This submission has been prepared by Kathy Civardi and Braydon Heape, members of the Financial Services Group at Henry Davis York. Their contact details, together with details of other partners in the Financial Services Group, are set out below:

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