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Dear Sirs

Submission – Options Paper – Wholesale and Retail Clients

This letter is a submission in response to the Options Paper – Wholesale and Retail Clients issued in January 2011.

General comment

The tests to determine whether a client is retail or wholesale must be based on sound underlying principles of distinction – with a clear articulation of what is the true basis for determining when a client must only receive a financial product or service that meets the minimum requirements set down in the Corporations Act.

Equally, any test must involve the application of clear and unambiguous criteria that can be quickly applied to discern whether a client is wholesale or retail. The tests must not be so onerous as to effectively

The current tests quantitative thresholds may be criticised at least as being as too low through failure to keep pace with inflation with the consequent effective reduction of the threshold and failure remain relevant to the rationale behind a monetary limit but they do have the important regulatory and economic benefit of certainty of application. We acknowledge that the product value threshold has applied for some 20 years. Circumstances have changed both in terms of the cumulative effect of inflation since 1991 and the changes to retirement savings mean a greater number of people may have access to lump sum superannuation payments that would permit them to invest more than $500,000.

That being the case, we would support in principle an increase to the $500,000 product value limit so that it is more consistent with some measure of presumed financial sophistication. However, we would note that it is not necessarily the case that a dollar threshold should necessarily be equated with presumed financial sophistication. Rather, a dollar threshold can be, in principle, aligned with a presumed need for an investor with certain financial means to take responsibility for their investment decisions and to be presumed not to require the benefit of regulation for that reason, rather than merely because of presumed financial sophistication.

We would also support, in principle, ongoing indexation of a fixed dollar threshold and we note that indexation models based on GDP price deflators have been implemented in relation to the Foreign Acquisition and Takeovers Act without apparent insurmountable difficulty in application.

In principle, we support corresponding changes to the $250,000 income and $2.5 million assets test in section 761G(7)(c) (and section 708(8)(c) which is not mentioned in the Options Paper).

It is clearly contemplated that these thresholds would change over time, hence the ability to implement change through the Corporations Regulations. Assuming sufficiently regular recourse to this means for updating the thresholds would alleviate any need for incorporation automatic indexation.

Responses to specific questions

Our views about the specific questions raised in the January Options Paper follow:

Section 7.4 – Update the Product Thresholds

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

An objective test is preferable from the point of view of ease and certainty of application. Any objective test should not be arbitrary. There should be clear and understood rationale underlying a test indicating why a degree of sophistication or assumption of informed investment choice is assumed. For instance, objective indicators other that dollar amounts could be minimum relevant education and experience or actual receipt of financial advice. Any reliance on investor declarations would be predicated on investors being informed as to the consequences of giving a declaration.

Should all three 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?

All three thresholds should be updated.

Is $1,000,000 an appropriate new threshold limit for the product value test?

A rationale needs to be developed to underpin any new threshold. While any figure might in some sense be arbitrary, a figure based on a developed rationale is to be preferred.

Contrary to a statement in the paper, there is no financial product value threshold has in the USA of $1 million. As we understand it, in the USA, there is a net worth threshold of $1 million which excludes the value of the investor's primary place of residence. We also note that the SEC is considering amendments to this test at present.

Is information available on how many investors would meet the proposed new limit for the products?

We are unable to comment.

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?

We can see merit in a test for investment in derivatives accurately reflecting the total economic exposure of the client.

Section 7.5 – Introduce an indexing mechanism

How could a simple and relevant indexing mechanism be introduced?

As noted above a GDP price deflator has been implemented in relation to foreign investment thresholds. A general CPI indexation measure could equally be used.

We consider that a simple, transparent and widely understood measure should be used. Any indexation must result in a threshold that is published and readily available so that there is no confusion at any time as to the applicable threshold.

Will three different threshold limits and constant indexing be too difficult or confusing to implement?

No. As long as the indexing is relatively simple and transparent, then theoretically market participants should be able to implement it. We are unable to comment on administrative difficulties that actually occur.

We observe that changing an investor's status in relation to a particular product after the time of acquisition of the product due to indexation could involve significant administrative difficulties. We assume that this would not be intended if indexation was implemented.

We suggest that indexed figures are rounded to, say, the nearest $25,000 for administrative simplicity.

What value should be used as the basis for indexing?

As noted above, we believe that the three thresholds should, in principle, be reviewed and any required indexing should be based on reviewed monetary thresholds.

How often should the three limits be indexed?

Annual or bi-annual indexation would seem to be appropriate.

Section 7.6 – Exclude Illiquid Assets

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

Consistent with the approach in the US, we think there is merit in excluding the value of a principal place of residence from an "assets test" for individuals such that the test is more aligned with a measure of assets available for investment.

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

As a matter of principle, the test should be based on assets that are made available for investment which would logically include superannuation. Whether or not a client "engages with" their superannuation account may not be relevant. In addition, some clients would have considerable wealth in superannuation accounts. We would add a question – is there evidence that the current inclusion of superannuation in relation to the s761G(7)(c) test results in inappropriate outcomes?

Would excluding some assets cause too much difficulty or confusion for industry? Which assets?

Any test should be kept as simple as possible. Valuation requirements for any assets that are to be excluded would have to be specified. This could perhaps be dealt with by requiring a valuation not more than 2 years old (as with the current accountant's certificate requirements for salary and assets tests under s761G(7)(c)). Otherwise, we do not think difficulty or confusion would necessarily result from excluding either the primary place of residence or superannuation accounts.

Would this work prohibitively to exclude clients who should be classified as wholesale?

We are unable to comment.

Section 7.7 – Amend the Deeming Process

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

In principle, we support the need for an investor to consent to being treated as a wholesale client, provided that meaningful disclosure could be conveyed as to the consequences of such consent and that the absence of such consent does not force issuers to issue a PDS or prospectus, but rather an issuer has an option of not dealing with a person who wishes to be treated as a retail client.

Would an explicit opt-in be prohibitively inefficient for industry?

If the opt-in were part of the application process (effectively preventing issues of products) rather than preventing distribution of product offers, it is difficult to see why it would be any more onerous than collecting accountant's certificates for wholesale clients. However, we assume that it would be more onerous, if as mentioned above, an opt in mechanism would require a PDS or prospectus for all products for instance because an offer document could not be given to a person unless an opt-in certificate had first been collected.

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

Investors need to be encouraged to take personal responsibility for their investment decisions and read the forms that they are signing. If there is clear, concise and prominent disclosure of the fact and consequences of choosing a "wholesale investment" - that investors should understand an investment before they select it and obtain financial advice about it - then the policy objective should be met. It would for instance be equivalent to the requirement for a Consumer Credit warning as to any declaration that an investment is not for personal, household or domestic purposes.

It should be borne in mind that there is also a key important policy objective to ensure that regulation does not discourage investors from being financially responsible and provides incentives to be financially sophisticated.

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

Investors should be able to elect to be treated as a retail client in relation to particular investments notwithstanding that they meet the threshold for a wholesale client. This would not require a positive election. The client should be entitled to remain silent and by investing in products pursuant to a PDS or prospectus be treated as retail for that purpose.

Section 7.8 – Two out of Three Requirements

Are there any specific reason why meeting one out of three requirements is better than meeting two out of the three (or vice versa)?

Meeting "two out of three" requirements would introduce unnecessary complexity. There is, in our view, no cogent evidence that the "one out of three" approach of the current form of regulation is subject to serious defects or shortcomings or that a "two out of three" approach would lead to better policy outcomes.

Is meeting the two out of the three requirements likely to be a better proxy for financial literacy than the current test?

This question is subject to an implicit assumption that the requirements are merely proxies for financial literacy. That is not necessarily the case. Where it is not the case, persons with access to a certain minimum level of financial resources or making a specified minimum investment could be expected to have the ability to obtain financially literate advice or otherwise be responsible for their investment decision.

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

It would obviously be more difficult for investors to be classified as wholesale. We cannot comment whether it would be prohibitive.

Section 7.9 – Introduce extra requirements for certain complex products

What are the complex products that the higher thresholds should apply to?

We note that no question is posed as to whether a higher threshold for complex products is warranted.

We consider that it would be very difficult to devise a relevant test as to what qualifies as a complex product in contrast to a simple product.

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

As above, if there is a higher threshold it should only be imposed based on extensive research and evidence.

Section 7.10 – Repeal the 'Sophisticated Investor' Test

Should investors with less wealth but high financial literacy have some way of accessing wholesale products?

Yes.

There is no reason to repeal s761GA. While we understand that s761GA is little used, the test appears to have a logical basis and its application can allow informed investors to access products and services that might otherwise not be available to them. It therefore appears to be beneficial provided the test is applied appropriately.

Given that industry favours objective tests over subjective tests, is this a strong enough reason to repeal the section entirely?

No.

The existence of one subjective test among a number of tests, some of which are objective, is not in itself objectionable. The situation is different in kind from a situation where all tests are subjective. The fact that the test is subjective is not in itself a strong enough reason to repeal the section. Evidence of misuse of the test, for instance to induce unknowledgeable investors to acquire sophisticated products or services might suggest a need to ensure that that the licensee and product or service provider were independent. However, we are not aware of such misuse of the test.

Should the section be retained even if it is scarcely used?

The fact that a provision is scarcely used is not a sufficient reason to repeal it. It may, however, be a compelling reason to improve it. Perhaps thought should be given to self certification by an investor based on categories of products and after taking into account the consequences of certification set out in a standardised warning. Alternatively, perhaps there should be exclusion based on certification by the client that they are investing after taking advice from a licensed adviser about the product. Of course, this assumes an otherwise robust independent adviser regime.

Section 7.11 – Remove the distinction between wholesale and retail clients

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

We are unable to comment.

Is the loss in efficiency offset by greater investor protection?

In our view, this proposal would represent a fundamental change to the regulation embedded in the Corporations Act. The wholesale/retail distinction underpins not only the regulation of financial services in Chapter 7 but structural regulation applied to debenture, securities and managed investment scheme offerings. The wholesale/retail distinction has been a fundamental part of the investment and financial services industry for a considerable period, is well understood by the industry and investment public and has not been shown by cogent evidence to be fundamentally flawed. Not only would there be a loss in product efficacy through the need to treat all investors (and consequently, products) as retail, but also the

adjustment costs for industry would be excessive. One unintended consequence may be that attractive wholesale investment opportunities are not made available due to compliance costs and excessive regulatory restrictions on product structure and operation that are not commensurate with investor protection needs.

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

No.

Section 7.12 – Introduce a 'sophisticated investor' test as the sole way to distinguish between wholesale and retail clients

Is the test under s761GA a true indication of financial literacy?

As outlined above, we would submit that a purely subjective test would be very difficult and costly to administer and a simple "bright line" test or tests should at least co-exist with the subjective test.

Is there any way that s761GA can be amended to allay fears of licensees being exposed to legal liability while maintaining investor protection?

It would be necessary to amend s761GA to make it more prescriptive with "black and white" tests that could be applied. Effectively this is likely to limit those who qualify to financially trained investors. An alternative would be to allow guidance to be given in regulations or by ASIC as to how the requirements of s761GA(d) can be satisfied.

Is it possible for a subjective test to be easy to administer and ensure that intermediaries are not unduly cautious?

In our view, no. The uncertainty inherent in a subjective and uncertain test will lead careful and prudent market participants to be cautious. Other less careful and prudent participants may, however, exploit such a subjective test.

Section 7.13 – Do Nothing

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

This question assumes that problems experienced during the GFC would justify reform of the distinction between retail and wholesale clients. In our view, the Australian regulatory (and for that matter prudential) systems performed very well by world standards during the GFC. It has not been shown that the retail versus wholesale distinction was a material cause of significant problems during the GFC, or that different regulatory settings would have produced different outcomes during the GFC.

Are the monetary threshold limits irrelevant?

As noted above, we would in principle, support the review of the monetary threshold limits.

Should they be increased? If so, by how much?

See our comments above.

Section 8.1 – Further Considerations

Is the professional investor definition still valid?

In our view, yes. Certain classes of investors should be expected to look after their own interests and not require the protections and detriment of attendant product constraints and expense given to retail investors.

Do any classes of investors need to be added or removed from listed professional investors?

In our view, there is no evidence that the professional investor definition is subject to defects in principle or in practice. However, resolving the differences between the application of the professional investor tests under section 708(11) and 761G(7)(d) should be considered.

Should professional investors continue to be subject to the same protections and disclosures that they currently receive?

Yes. We are not aware of evidence that indicates that reform is required in this regard.

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If you wish to discuss this submission, please contact John Keeves on (02) 8274 9520.

Yours faithfully