
Options Paper on Wholesale and Retail Clients (Future of Financial Advice)

Submission to Treasury

Prepared by

The Corporations Committee of the Business Law Section of the Law Council of Australia

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Introduction

Submission

The Corporations Committee of the Business Law Section of the Law Council of Australia (“**Law Council**”) offers the following submission in relation to the Department of Treasury’s *Options Paper on Wholesale and Retail Clients (Future of Financial Advice)* (“**Options Paper**”).

Approach to submission

The Law Council is supportive of an objective of reforms aimed at improving disclosure, particular risks disclosure to investors who due to lack of financial experience and individual wealth are in less of a position to assess and absorb risk.

However, the Law Council has is not of the view that such policy aims are necessarily achieved through significant changes to the distinction between retail and wholesale concepts, nor is it of the view that reform is necessary in this regard.

In this submission, the Law Council has considered the broad range of possible options put forward in the Options Paper and has provided responses accordingly although has not responded to all of Treasury’s specific consultation questions, and has selected key questions to which to respond.

Initial observations

The Options Paper discusses the distinction between wholesale and retail investors, as used in the context of offerings of specialised financial products. However, any change to those concepts would – unless limited to those specialised financial products – have significant consequences for listed companies and trusts, where the same concepts are central to capital markets activity.

Overriding factors for consideration

We note that the Options Paper sets out some important factors considered relevant to evaluating the tests to distinguish between wholesale and retail and the options for reform, namely:

- Providing adequate protection and disclosure to clients who need it
- Ensuring that any test takes into account the financial literacy of the client, including their ability to assess the merits, value and risks associated with particular financial products, as well as understanding their own information needs and the adequacy of information provided by the intermediary
- Whether an client is willing and able to pay for professional advice
- Ensuring that the investor is fully aware/ informed of their status as a retail or wholesale client
- Encouraging efficiencies in the financial services industry
- Ensuring that any regulation which prohibits or limits access to certain wholesale products is justified

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- Ensuring that the test is easy to use, clear and as objective as possible to give industry sufficient certainty
 - Ensuring there is some consistency across the Corporations Act
 - Ensuring that the test will remain relevant with time
 - Considerations of international consistency

These submissions and responses to the questions set out in the Options Paper give consideration to these factors.

References below to “Parts” are to parts of the Options Paper.

Option 1 - Retain and update the current system

“Option 1 is to retain the current distinctions between retail and wholesale clients but update them to better reflect and take account of the problems encountered during the GFC and the time which has elapsed since the current tests were enacted. There are various mechanisms for implementing this option which are outlined below. Please note these mechanisms are not mutually exclusive and multiple mechanisms could be adopted to achieve the policy outcome.”

Update the product thresholds (Part 7.4)

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

It is our submission that an arbitrary but objective threshold is preferable (at least as one of the available thresholds), as it provides greater certainty and enables classification of investors to be undertaken without undue expense or procedural requirements.

There is a need for certainty and efficiency in undertaking a range of corporate actions. It is significant for the conduct of wholesale offers of securities and financial products, for “accelerated” securityholder offers that have been a significant feature of the capital markets in recent years, and to facilitate foreign offers being extended to Australian investors.

Accordingly, whilst the Law Council acknowledges that wealth is not necessarily a proxy for financial experience or knowledge, the benefits of a relatively straightforward monetary threshold outweigh any concerns regarding the potential for arbitrary application.

Further, the Law Council is of the view that the flexibility provided by the tests section 708(10) and section addresses the concerns arising from the potential arbitrary application of a monetary threshold and allows investors who actively want to participate in the wholesale market to “opt-in”.

- ***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?***

The Law Council is of the view that determination of the threshold level is a matter of policy as opposed to a matter concerning legal effectiveness and therefore feels that it is

unable to comment on what the threshold should be. However, the Law Council has not encountered difficulties with the current threshold in industry practice.

Further, the Law Council is of the view that currently this is a well-understood market limit and change would result in transitional problems in relation to many instruments currently on issue that have been structured according to the current thresholds without provision or allowance for variations in the thresholds.

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

See above.

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

The Law Council is 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?***

The Law Council has no comment to make on this question.

Introduce an indexing mechanism (Part 7.5)

- ***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.***
- ***Will three different threshold limits and constant indexing be too difficult or confusing to implement?***
- ***What value should be used as the basis for indexing?***
- ***How often should the 3 limits be indexed?***

The Law Council does not support this proposal.

Exclude Illiquid Assets (Part 7.6)

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

The Law Council notes that the increase in household wealth reflects, in part, increases in land values but is not necessarily indicative of an increase in disposable income or financial experience. However, it is the view of the Law Council that this issue is one of policy and not one the Law Council is prepared to comment upon.

- ***Are there any specific reasons why superannuation should/should not be included in the net assets test?***
- ***Would excluding some assets cause too much difficulty or confusion for industry? Which assets?***

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

Introducing a test requiring valuation of land or other illiquid assets would require potential investors to obtain more complex (and presumably, more expensive) accounting sign-offs as to financial net worth and land valuations, increases the cost and difficulty of entry into financial markets.

The measures regarding exclusion of superannuation and residences from a net assets test appear to be directed towards excluding classes of assets that otherwise render retirees more likely to be classified as “wholesale”. Whether this is appropriate is an issue of policy and the Law Council does not propose to comment.

Amend the Deeming Process (Part 7.7)

- ***Would this work prohibitively to exclude clients who should be classified as wholesale?***
- ***Would an explicit opt-in be prohibitively inefficient for industry?
- What would be a more appropriate test for investor opt-in?***
- ***Would the true policy objective and message be easy to avoid via standard forms?***
- ***Should investors be able to elect to be treated as a retail client even when they meet the wholesale wealth threshold tests?***

An opt-out option is not a desirable reform, if it allows investors to change their status on an offer-by-offer basis. It would, for instance, introduce uncertainties into register analysis that would potentially frustrate institutional and accelerated capital raisings, and could potentially reduce the availability of underwriting or increase underwriting costs. Incidental effects may be to reduce certainty of capital raising execution and extend time frames for capital raisings.

Wholesale investors can decline to participate in an offer if they are not satisfied with the level of disclosure or the timeframe offered for consideration of the offer.

Two out of three requirements (Part 7.8)

- ***Are there any specific reasons why meeting 1 out of 3 requirements is better than meeting 2 out of the 3 (or vice versa)?***
- ***Is meeting 2 of the 3 requirements likely to be a better proxy for financial literacy than the current test?***
- ***Would this requirement be prohibitive for investors who wish to be classed as wholesale?***

There is no obvious reason why it would be advantageous to require more than one of the current requirements to be satisfied, for an investor to be classed as wholesale. While the tests may be somewhat arbitrary, they are well understood by the market and have the advantage of certainty and relative simplicity.

Introduce extra requirements for certain complex products (Part 7.9)

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

The Law Council is of the view that the introduction of a complex products test would fundamentally change the current disclosure regime and is a reform of such a scale to warrant a separate inquiry into and analysis of any proposal.

Introduction of a product-by-product disclosure regime would require an additional layer of regulation regarding the classification of the financial product offered. If cast narrowly, it would inevitably lag the market and be ineffective; if cast broadly it would risk stifling positive innovation in structured products and increase the costs associated with valid investment products.

This Option assumes that complexity and risk are proportionally related. However, this is overly simplistic. For example, hybrid securities issued by the major Australian banks are complex, yet have become well understood in the market and provide stable investment returns and have not involved significant risk notwithstanding their complexity.

There can be a risk that complexity inhibits some investors' *ability to assess the risk* associated with a product. However, if a regulatory response was to limit access to complex products to professional or sophisticated investors, that would also have the effect of denying retail investors access to products that may offer attractive returns and which may involve less risk than ordinary equity.

A move towards classifying products by complexity or perceived risk, and imposing additional regulatory requirements (which would reduce the likelihood that those products would be developed or offered) would be a shift towards merit regulation, which can raise administration and compliance costs which may not be justified by the benefits of increased regulation of those products, while reducing the opportunity for diversification of investments.

An alternative approach, more consistent with a disclosure regulation framework, would be to consider disclosure principles capable of more general application across all products, which improve disclosure standards and facilitate the assessment of risk. However, any such proposal would be of sufficient significance as to merit a separate inquiry and consultation process.

Repeal the 'Sophisticated Investor' test (Part 7.10)

- ***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?***
- ***Given that industry favours objective tests over subjective tests, is this a strong enough reason to repeal the section entirely?***
- ***Should the section be retained even if it is scarcely used?***

There is utility in having a subjective test available, to address circumstances where the objective tests produce a result that would unfairly restrict a financially literate investor

from accessing wholesale products. The Law Council does not support repeal of the sophisticated investor test.

Conclusions on Option 1

The Law Council does not perceive a pressing need to change or update the current tests and thresholds that would justify the costs and other incidental impacts of the suggested changes.

Option 2- Remove the distinction between wholesale and retail clients (Part 7.11)

“In order to minimise the problems and complexities associated with having 2 separate classes of investor, this option would eliminate the distinction between wholesale and retail clients.

All investors (except professional investors as defined in section 9 of the Corporations Act) would receive the protections and disclosures currently afforded only to retail clients. This would remove distinctions which can sometimes be arbitrary and difficult to administer and ensure that there is consistency and simplicity across the Corporations Act.”

- ***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?***
- ***Is the loss in efficiency offset by greater investor protection?***
- ***Is it appropriate to remove the distinction from the entire Act?***

This proposal would have the effect of preventing Australian entities from rapid access to institutional capital, which would have incidental effects on mergers and acquisitions activity and capital management strategies of Australian entities. It would also take Australian securities laws significantly out of line with international securities law regimes, and would tend to increase the extent to which Australian entities seek to raise capital offshore, rather than from the domestic market.

Conclusions on Option 2

The Law Council does not support this option.

Option 3 - Introduce a ‘sophisticated’ investor test as the sole way to distinguish between wholesale and retail clients (Part 7.12)

“The most accurate distinction between wholesale and retail investors would likely be based on the actual financial literacy of the investor. This option recognises that a distinction based on wealth is arbitrary and that a true measure of financial literacy should be the test used to distinguish retail clients from wholesale clients. Investors with

high financial literacy have less need for specific disclosure due to their ability to understand the merits, value and risks of a particular financial product; and less need for specific protections (such as access to external dispute resolution scheme) as they are more able to protect their own rights and interests.”

- ***Is the test under section 761GA a true indication of financial literacy?***
- ***Is there any way that section 761GA can be amended to allay fears of licensees being exposed to legal liability while maintaining investor protection?***
- ***Is it possible for a subjective test to be easy to administer and ensure that intermediaries are not unduly cautious?***

This proposal would increase uncertainty in register analysis, with negative effects on the execution risk and timing for capital raising initiatives, and would be likely to increase costs for investors and offerors to an extent which would not be justified by any regulatory benefit.

Conclusions in relation to Option 3

The Law Council does not support this option.

Option 4 - Do nothing (Part 7.13)

“Despite the apparent problems experienced during the GFC due to the current distinction between wholesale and retail clients, it is possible to retain the existing tests and thresholds.”

- ***Is there any reason why the current tests should be retained in the face of problems experienced during the GFC?***
- ***Are the monetary threshold limits still relevant?***
- ***Should they be increased? If so, by how much?***

This is a viable option.

Further Considerations

Professional investor (Part 8.1)

In addition to the options canvassed above, a supplementary question for consideration is whether the definition of ‘professional investor’ in section 9 of the Corporations Act is still relevant. The professional investor definition has not been significantly amended since FSR. Professional investors are generally excluded from all retail client protections, given their resources and assumed high level of financial literacy.

- ***Is the professional investor definition still valid?***

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- ***Do any classes of investor need to be added or removed from the list of professional investors?***
 - ***Should professional investors continue to be subject to the same protections and disclosures that they currently receive?***

It is worth considering whether professional investors, who are investing on behalf of retail clients in conjunction with an advisory mandate for those retail clients, should not be treated effectively as “retail” because of the underlying investor.

Superannuation products (Part 8.2)

“There is currently some confusion regarding whether “in relation to a superannuation product” in s761G applies to financial services and product made available to the trustee of a superannuation fund (other than superannuation products).”

- ***A final question for consideration is whether clarification is needed regarding the interpretation of s761G.***

The Law Council has no comment to make on this question.

Concluding comments

While it is appropriate to be assessing the issues and questions contained in the Options Paper, this is not an area of regulation where there is a pressing need for reform.

Whatever response is implemented (if anything), further distinctions within the regulatory regimes for listed products should be avoided, and symmetry of regulation for listed products under Chapter 7 and Chapter 6D of the Act should be pursued.

The Law Council does not believe that an overhaul of the distinction between retail and wholesale concepts, or revision of the nature or level of the current thresholds would significantly improve regulatory outcomes nor necessarily avoid the concerns of the Department of Treasury as outlined in Part 4 of the Options Paper.

The Law Council has not objection to policy measures which encourage more investors to seek appropriate financial advice. However, these measures would not appear to have that effect and would have other incidental effects which would not be of benefit to the capital markets or, ultimately, to investors.

The Law Council would be willing to consult further with the Department of Treasury in relation to this submission and the proposals in the Options Paper.

If the Department of Treasury wishes to discuss this submission, please contact any of the following: Stuart Byrne, Clayton Utz (*direct line (02) 9353 4722, email sbyrne@claytonutz.com*), or Shannon Finch, Mallesons Stephen Jaques (*direct line (02) 9296 2497, email shannon.finch@mallesons.com*).

Attachment A: Profile of the Law Council of Australia

The Law Council of Australia is the peak national representative body of the Australian legal profession. The Law Council was established in 1933. It is the federal organisation representing approximately 50,000 Australian lawyers, through their representative bar associations and law societies (the “constituent bodies” of the Law Council).

The constituent bodies of the Law Council are, in alphabetical order:

- Australian Capital Territory Bar Association
- Bar Association of Queensland Inc
- Law Institute of Victoria
- Law Society of New South Wales
- Law Society of South Australia
- Law Society of Tasmania
- Law Society of the Australian Capital Territory
- Law Society of the Northern Territory
- Law Society of Western Australia
- New South Wales Bar Association
- Northern Territory Bar Association
- Queensland Law Society
- South Australian Bar Association
- Tasmanian Bar Association
- The Victorian Bar Inc
- Western Australian Bar Association
- LLFG Limited (a corporation with large law firm members)

The Law Council speaks for the Australian legal profession on the legal aspects of national and international issues, on federal law and on the operation of federal courts and tribunals. It works for the improvement of the law and of the administration of justice.

The Law Council is the most inclusive, on both geographical and professional bases, of all Australian legal professional organisations.