McMAHON CLARKE LEGAL

Submission—Future of Financial Advice—Options Paper on Wholesale and Retail Clients

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1. About McMahon Clarke Legal

McMahon Clarke Legal was established in 1994 and has been active in the managed investments sector since its inception. Our clients include managers and trustees under the former prescribed interest regime (the predecessor to the managed investment laws) and we now act for responsible entities and other stakeholders operating in the managed investment sector.

We have been very focused on legislative reform, particularly in the area of managed investment schemes. The firm has written two books *Everything you need to know about property syndication: explaining the myths surrounding illegal property syndicates* and *Everything you need to know about agricultural investment prospectuses: establishing a project under the Managed Investments Act 1998*. Our former and current partners have filled executive roles within industry associations including the *Australian Direct Property Investment Association,* the *Managed Investments Industry Association* and the *Australian Shared Ownership and Fractional Association Limited*.

The firm also produces regular newsletters with a managed investment focus and speaks extensively at external conferences, our own seminars and to the media.

We have most recently prepared submissions in response to the following:

(a) ASIC consultation paper 142 *Related party transactions.*

(b) ASIC consultation paper 141 *Mortgage scheme: Strengthening the disclosure benchmarks.*

(c) ASIC consultation paper 140 *Responsible entities: Financial requirements*.

(d) ASIC consultation paper 133 *Agribusiness managed investment schemes: improving disclosure for retail investors*.

(e) ASIC consultation paper 123 *Debentures: strengthening the disclosure benchmarks*.

(f) Submission on the *Corporations Amendment No. 2 Bill 2010*.

(g) Submission to the Commonwealth Treasury on the draft *Corporations Amendment Regulations 2009* and example product disclosure statement.

(h) ASIC consultation paper 100 *Unlisted property schemes: improving disclosure for retail investors*.

(i) ASIC consultation paper 99 *Mortgage schemes: improving disclosure for retail investors*.

(j) ASIC consultation paper 89 *Unlisted, unrated debentures: improving disclosure for retail investors*.

(k) ASIC consultation paper 81 *Management rights schemes*.

(l) Parliamentary Joint Committee on Corporations and Financial Services: Inquiry into agribusiness managed investment schemes.

2. Purpose of this submission

This submission is reply to the options paper titled "Wholesale and Retail Clients", released as part of the Future of Financial Advice (FOFA) Reforms (the Options Paper).

In this submission we have set out our response to the specific consultation questions put forward in the Options Paper along with our general comments on the Options Paper.

References in this submission to chapters, parts and sections are to chapters, parts and sections of the *Corporations Act 2001* (the Act).

3. Initial comments

3.1 Identifying the Government's real concern

Firstly, we would like to express some concerns about the basis on which the need to consider whether the current distinction between wholesale and retail clients in the Act should be reviewed has been predicated.

We have expressed these concerns more particularly below, but it would appear that the Government's key concern relates to wholesale investors (who may not be particularly financially literate) being able to invest in complex derivatives-based products (such as collateralised debt obligations and contracts for difference).

If it is indeed the case that this is the Government's key concern, then we submit that the Government should take a more focussed approach to regulating an investor's ability to acquire those specific financial products as a wholesale client; rather than amending the retail/wholesale client thresholds which apply to all financial products and financial services.

This is because the retail/wholesale client test is a blunt regulatory tool and making amendments to the way in which it operates to cure perceived issues with a particular class of financial product is not an efficient implementation of policy.

We are particularly concerned that some of the options in the Options Paper, if implemented, would have a significant effect on the ability of small financial product issuers to structure wholesale products and would reduce the level of innovation within the Australian financial services industry (given the regulatory costs involved in offering financial products and services to retail clients, often new products and services are created in the wholesale client market first, and then offered to retail clients later).

3.2 Incomplete reliance on rises in asset prices and average incomes

Point 2.3 of the Options Paper, states as follows:

"2.3 The threshold for product value was set at $500,000, as compared to average total earnings for Australian full-time workers which were around $29,300 in 1991 rising to around $67,700 in 2010. The level of $500,000 is a level now within reach of an increasing number of Australians, given that in June 2010 the median value of a house in Australia was $558,540. The other main asset now owned by most Australians is superannuation. The Australia Bureau of Statistics (ABS) has estimated that of the approximately 2 million Australians, who have received, or will receive, a superannuation benefit in 2007, 55 percent had taken their superannuation benefit entirely as a lump sum, 35 percent as a pension and 10 percent as a combination of the two. An asset purchased in 2000 for $500,000 would now be worth $681,855 if it just appreciated at the prevailing rate of inflation. Accordingly, even taking into account just inflation on average weekly earnings, the threshold of $500,000 needs to be revised to keep pace with inflation."

On the basis of the statement above, the Options Paper makes the assertion that Australians now have access to significant sums of money. However, the underlying premise of the above statements is limited because it focuses solely on gross rises in asset prices since the thresholds were introduced, without also considering the rise in household debt over the same period.

In addition, the changes to "average" total earnings for Australian full-time workers over the relevant period is also distorting because it does not take account of asymmetry of distribution of incomes in Australia. Instead, changes in

"median" income earnings for Australians should be used to analyse whether incomes have increased significantly over the relevant period.

In relation to household debt, over the last 18 years the total amount of debt owed by Australian households rose almost six-fold. Importantly, the level of that household debt relative to assets shows that between September 1990 and September 2008 the ratio of total household debt to assets held by households rose from 9 percent to 19 percent; in other words, debt grew twice as fast as the total value of assets held by households.[1]

In addition, a proportion of low income households in the top two income quintiles owed almost two-thirds (64 percent) of all debt. Meaning that it is the wealthiest households who have the most debt. It is imperative that the Government does not rely simply on changes in gross asset prices over a period to determine whether the wholesale client thresholds need to be changed. Instead, the Government needs to carefully review the data and take into account the increase in household debt over the same period[2].

In relation to income, whilst we agree income has increased significantly since the introduction of the thresholds, the increase in "median" income is somewhat lower. For example, in 2007 – 08 whilst the mean equivalised disposable household income of all households in Australia was $811 per week, the median was somewhat lower at $692.[3]

This difference illustrates the point that there is an asymmetric distribution of income in Australia; where a relatively small number of people have relatively high household incomes, and a large number of people have relatively lower household incomes.

This is a particularly important point in the current context, where the Options Paper expressly places reliance on increases of "average" earnings as the basis for the need to increase the thresholds.

3.3 A lack of evidence

The Options Paper makes a number of assertions to the effect that the Global Financial Crisis exposed problems with the current retail/wholesale client

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[1] *"Household debt" Australia Social Trends 4102.0 2009.*

[2] See note 1 above.

[3] Australian Bureau of Statistics, Household Income and Income Distribution Australia 2007 – 08, 6523.0

distinction. However, the evidence given in support of those statements is limited.

In particular, the Options Paper focuses on the problems faced by local councils in investing in complex financial products such as collateralised obligations sold by Lehman Brothers.

However, local councils are investors who are already governed (at a State Government level) by investment orders and other investment frameworks set by State Governments.

The State Governments, such as the New South Wales Government, have already conducted inquiries into the issues faced by local councils in investing in complex financial products and have made a number of recommendations to avoid those issues arising again in the future.[4]

Where there is a separate regulatory regime that already governs what investments local councils can make, and those regimes have already taken steps to ensure that those issues do not arise with that particular class of investors in the future, we do not think the Government should also be taking steps, at a Commonwealth level, to change the Commonwealth framework.

Apart from the example of the issues faced by local councils, the Options Paper provides no other evidence of wholesale investors who have been able to show that if they had been treated as a retail client (and therefore provided with the required disclosure documents), they would have made different investment decisions.

Given the consequences the proposed changes in the Options Paper will have on the financial services industry, we submit it is incumbent upon the Government before embarking upon implementing any of the options outlined in the Options Paper to undertake further research into this issue and release the findings of that research to ensure there is in fact a real need to change the retail/wholesale client distinctions in the Act.

In our submission, the real reason for losses suffered by wholesale clients who did not fully understand the risks they were taking investing in complex financial products was that they were unfamiliar with the complex nature of the products and were focused on the increased in financial returns offered by those complex

[4] See the recommendations contained in the final report of the Review of New South Wales Local Government Investments by Michael Cole dated April 2008.

financial products. Those issues would not have been resolved through the issue of additional disclosure about the products.

The issue is that those particular products are complex and require a level of financial sophistication and financial literacy not possessed by the large majority of Australian investors.

4. Submission—Option 1—Retain and update the current system

4.1 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?

From a philosophical perspective, a subjective test which is directed at the individual circumstances of a client is preferable to an objective, but arbitrary test which uses wealth as a proxy for financial literacy.

However, as the industry utilisation (or, more particularly, the lack of industry utilisation) of the sophisticated investor test in section 761GA has shown, a subjective test which has the potential to impose additional liability on a licensee will not be used.

Consequently, it is highly likely that if a subjective test is implemented that licensees will choose not to use it, with the effect being that the retail/wholesale client distinction will become illusory in practice, so that most, if not all, investors will be treated as retail clients.

Consequently, we believe that an objective arbitrary test is preferable to a subjective test.

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?

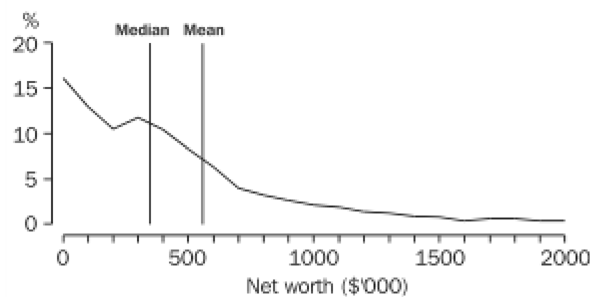
No, all three tests should not be updated; however, all three tests should be indexed (discussed below).

As noted above, the statements in the Options Paper regarding increases in asset prices since the introduction of the thresholds fail to recognise the accelerated growth in household debt over that same period. In addition, the statements in the Options Paper do not account for the fact that net worth and income are asymmetrically distributed in Australia.

To illustrate these points, the mean household net worth of all households in Australia in 2005-06 was $563,000; however, the median (i.e., the mid-point when all households are ranked in ascending order of net worth) was substantially lower at $340,000. This difference reflects the asymmetric distribution of wealth between households; where a relatively small proportion of households have high net worth and a relatively large number of households have low net worth.

Consequently, whilst asset prices may have greatly increased since the thresholds were introduced and it may now be possible for an investor to become "fortuitously wealthy", for example, by receiving a windfall inheritance or selling a principal place of residence which had no encumbrances; the thresholds are still beyond the reach of all but a very small percentage of Australian households.

The table below shows just how few households actually have $2.5 million in net wealth[5].



As noted above there is also an asymmetric distribution of income in Australia.

This is a particularly important point in the current context, where the Options Paper expressly places reliance on increases of "average" earnings as the basis for the need to increase the thresholds.

When considering these issues, the questions for determination as we see them are: What percentage of people, in a real sense, are able to satisfy the thresholds? And: Is that percentage so significantly greater than when the thresholds were introduced as to warrant increasing the thresholds?

[5] Source: ABS Cat. No. 6554.0 Household Wealth and Wealth Distribution, Australia 2005- 2006.

In answering those questions, one must look to the percentage of people who were able to satisfy the thresholds when the thresholds were introduced and compare that percentage to the current numbers.

The Government is better placed than anyone to undertake this analysis; however, from our perspective the table above illustrative of the point that the percentage of households that are able to satisfy the net wealth threshold is still very low.

Consequently, in our view, the evidence does not currently support a change to the income or net wealth thresholds.

With the above comments in mind, in our view, if the Government is minded to increase a threshold, the $500,000 product value threshold should be the threshold the Government increases. This is because, of the three thresholds, it is the threshold which is most likely to be satisfied by someone who becomes "fortuitously wealthy".

By that we mean those people who sell a single asset which has increased in value over time (for example the family home) or receive a windfall inheritance, will most likely be able to satisfy the product value threshold before being able to satisfy the net wealth or income threshold.

The reasons why a person in the “fortuitously wealthy” scenario would find it difficult to satisfy the income tests are obvious.

The reasons why a person in that scenario would be able to satisfy the product value threshold test before the net wealth tests are as follows:

(a) The net wealth test is a measure of "net" wealth, which means that a person who receives a large, one-off windfall would still need to take into account their existing debt when determining their net wealth.

(b) The net wealth threshold is currently five times higher than the product value threshold.

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

We do not think that the Government should implement a change to the product value threshold limit without first conducting some research and analysis into the effect that such a change would have.

Whilst we accept that any number chosen must be relatively arbitrary, we are concerned that a jump from $500,000 to $1,000,000 may be excessive and

unnecessary, leading to a stifling of development of products in the financial services industry.

We are also concerned that one of the reasons given in support of increasing the limit to $1,000,000 seems to be without basis, namely, that the United States has recently increased its product threshold component to $1,000,000.

The Options Paper itself lists the criteria for an "accredited investor", none of which include a product value threshold. In fact, so far as we understand it, the amendments introduced by section 413 of the Dodd-Frank Act in the United States, were only as follows:

(a) To require the Securities and Exchange Commission (SEC) to adjust the net worth standards for "accredited investors" in its rules under the Securities Act so as to exclude the value of the primary residence of a natural person in the calculation of a natural person's net wealth.

The SEC has clarified that it only proposes to adjust the net worth requirement by the net equity in the primary residence. That is, taking into account the level of debt secured against the primary residence.[6]

(b) To include a power for the SEC to "undertake a review of the definition of the term 'accredited investor,' as such term applies to natural persons, to determine whether the requirements of the definition…should be adjusted or modified."[7]

Under that new power, the SEC cannot increase the net worth standard until 21 July 2014. It must also conduct a review of the whole "accredited investor" test at least once every four years after that time.

However, the personal income test (which is currently $200,000 for a single person or $300,000 with a spouse) can change at any time after completion of the SEC's.

To our understanding, the above encompasses all of the changes made by the Dodd-Frank Act; there is no change to the product value threshold,

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[6] Securities and Exchange Commission Release Nos. 33-9177; IA-3144; IC-29572; File No. S7-04-11. Available at http://www.sec.gov/rules/proposed/2011/33-9177.pdf (accessed on 24 February 2010).

[7] Dodd-Frank Act, Pub. L. No. 111-203, § 413 (b)(1)(A).

indeed, it does not even appear that the United States has a product value threshold as one their tests for an "accredited investor".

What is worth noting about the changes the United States has recently made is that the changes, whilst being significant, are being implemented over a fairly long period of time and are being made based on decisions taken after future reviews by the SEC.

For example, the SEC is unable to review the net worth test for four years. In addition, the Frank-Dodds Act does not actually prescribe changes to the net worth test, but instead gives the SEC the power to make those changes.

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

We assume that an appropriately qualified economics consultancy firm would be able to provide an analysis of this issue, and we would hope that the Government would engage such a firm before taking any steps to implement any of the options in the Options Paper.

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 do not have any objection to the proposed amendment to regulation 7.1.22.

4.2 Introduce an indexing mechanism

How could a simple and relevant indexing mechanism be introduced?

We think that instead of trying to apply an arbitrary formulation for indexation, Treasury should be empowered to review the thresholds every five years. This would be adopting a similar model to that used in the United States.

In undertaking their review, Treasury should be required to consider similar factors as those required to be considered by the SEC in the United States, namely—

(a) the protection of investors

(b) the public interest, and

(c) the state of the economy (both the current state of the economy and changes in the economy since the previous review).

Before implementing any changes to the thresholds, Treasury should be required to call for submissions on the proposed changes.

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

No, we do not think that an indexing model based on a Treasury review every five years would be too difficult or confusing to implement. We think that, provided Treasury and the Australian Securities and Investments Commission (ASIC) both had a dedicated page on their websites stating the current thresholds, this would not be too difficult or confusing to implement.

However, we think that the Government would need to give careful consideration to how any transitional periods would apply under an indexing arrangement. For example, it would need to be clear that any changes to the thresholds as a consequence of a Treasury review would only be prospective, and would not affect investors who might previously have invested in a fund as wholesale clients, but who no longer qualified as wholesale clients.

Likewise, a clear regime would need to be established for those investors who had invested in a fund as a wholesale client, but because of changes to the thresholds no longer qualified as wholesale clients, and wished to make a further investment in that fund.

Consideration would also need to be given to how this regime would operate for a fund which had issued partly-paid securities to wholesale clients.

For example, it would seem unworkable if an investor, who no longer qualified as a wholesale client because of a Treasury review, was able to avoid liability for a future call on a partly-paid security made by the operator of the fund.

What value should be used as the basis for indexing?

As noted above, in our view, Treasury should be empowered to undertake a review of the thresholds every five years. Adopting this model would avoid using an arbitrary calculation for determining changes to the thresholds.

For example, by using a review model, Treasury would be able to take into account wealth destroying events such as the Global Financial Crisis and other cyclical economic changes, which an arbitrary measure, like an inflation measure, would not.

How often should the three limits be indexed?

We think that a review to the thresholds every five years would be the most suitable time frame.

4.3 Exclude illiquid assets

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

In our view there is no need to remove a primary residence from the net assets test. As demonstrated above, the net assets test in Australia is already very high and largely unattainable for all but a very small minority of the population.

In addition, as pointed out in the Options Paper, excluding the primary residence from the net worth test would distort the types of investors that could qualify as a wholesale client.

If the Government did decide to exclude the primary residence from the net assets test, then the Government should follow the SEC's approach and not exclude the equity value of the primary residence.

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

Superannuation should not be removed from the net assets test because it is unnecessary and will lead to distorted outcomes. It is unnecessary because, as already outlined above; Australia already has a very high net asset threshold requirement.

It will distort outcomes because it will penalise those investors who, at the Government's encouragement[8], have made additional contributions to their superannuation at the expense of investing in other forms of financial assets.

Further, regard needs to be had to the fact that many Australians actively manage their superannuation saving through self-managed superannuation funds, and, through that management have acquired considerable levels of financial literacy.

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[8] Such as tax incentives and community education programs.

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

Yes, in our view it would cause too much confusion.

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

Yes, for the reasons set out above it would work prohibitively to exclude clients who should be classified as wholesale.

4.4 Amend the deeming process

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

In our view, it is unlikely that an explicit opt-in would make investors sufficiently aware of the protections they are afforded. The Options Paper is correct to assume that licensees and advisors would adopt standard forms to deal with an opt-in process. It is entirely proper for them to do so; given this would be the most efficient means of satisfying the regulatory requirement.

In our experience investors do not read or consider much, if any, of the disclosure they are given as part of the acquisition of a financial product or service so we find it difficult to see how the disclosures made through an opt-in process would be any different.

Would an explicit opt-in be prohibitively inefficient for industry? What would be a more appropriate test for investor opt-in?

Yes, an opt-in would simply add an additional regulatory layer which would need to be complied with in offering a financial product or service. Those increases in inefficiencies would not be warranted, given that we do not believe there would be any real policy benefit in implementing an opt-in system.

We do not believe that an explicit opt-in system has any merit so we do not believe that there is in fact a test which would be more appropriate for implementing an opt-in arrangement.

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

For the reasons set out above, yes.

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

Yes, however, the election should only be able to be made once, at the time of acquiring the financial product or service. This is because many financial products are only offered to wholesale clients (such as an unregistered managed investment scheme) under the various exemptions in the Act for offers made to wholesale clients (such as the excluded offer provisions in the Act).

If investors were able to choose, after they had acquired the relevant financial product, to be treated as a retail client it would not be possible for issuers of financial products or providers of financial services to appropriately structure new wholesale products or wholesale financial services.

4.5 Two out of three requirements

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

We do not believe there are any specific reasons why meeting two out of the three requirements is better than meeting one out of the three. As the Options Paper points out the use of wealth as a proxy for financial literacy is both flawed and arbitrary.

However, what is important is that if investors are able to show that they can satisfy any of the three requirements then they are more likely to have the financial wherewithal to engage a financial adviser to advise them on the merits or otherwise of investing in a financial product or acquiring a particular financial service.

When one bears in mind that an investor who can meet one of the three requirements would most likely be able to afford the cost involved in obtaining financial advice with respect to a particular investment for a wholesale client and weighs that against the costs to the financial services industry of seeking to protect those people (who have the means to protect themselves) the changes are both inefficient and unnecessary.

Is meeting 2 of the 3 requirements likely to be a better proxy for financial literacy than the current test?

No, we agree with the Options Paper to the extent that it points out that wealth is not a proxy for financial literacy. Therefore, being able to demonstrate “more” wealth will not overcome the fundamental problem of using wealth as a proxy for financial literacy.

As noted above if an investor is able to satisfy any one of the three requirements, then they should also be able to obtain financial advice from a suitably qualified (financially literate) financial adviser to provide them with advice on their prospective investment.

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

Yes, being required to meet two out of the three requirements would be prohibitive for investors who wish to be classed as wholesale.

4.6 Introduce certain requirements for certain complex products

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

As a starting point, those products which involve derivatives should be considered complex. We think the Treasury and ASIC should work together to review the financial products and services being provided within the derivative space to produce a more narrow set of indicia of those particular products within a derivatives offering which are more complex.

For example, a simple options or futures product is clearly less complex than a synthetic derivate-based index that has a number of variables to determine the eventual return to investors.

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

We have discussed this below, but we believe an objective financial literacy test should be applied to investors who wish to invest in those products. See below for further comments.

4.7 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?

Yes. We firmly believe Treasury and ASIC should investigate implementing a simple objective financial literacy test which could be utilised by highly financially literate investors who may not be able to meet the wholesale client test in the Act.

In our view, the simple objective financial literacy test could consist of a financial literacy-style exam which could be taken by investors who wish to be certified as

a “sophisticated investor”. The test would be standardised and could be developed in conjunction with the members of the Financial Literacy Board.

The test could be implemented by sufficiently accredited members of the Financial Literacy Educators and Trainers Network.

In addition, the test could include specific derivative-based questions for those investors who wish to invest in complex derivative-based financial products.

In our view, implementing an objective financial literacy test in this matter would be the most direct and efficient means of allowing those investors who are financially literate but unable to meet the wholesale client test to gain access to wholesale products. In addition, this would be the most efficient and effective means of regulating investment in complex derivative-based financial products.

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

No, we think that whilst the current subjective test is not regularly used, it should remain in the Act to allow maximum flexibility for the industry.

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

Yes, some licensees would rely on it.

5. Option 2 – Remove the distinction between wholesale and retail clients

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?

In our opinion, imposing such an obligation on the financial services industry will be highly prohibitive and restrictive.

Is the loss in efficiency offset by greater investor protection?

No, as noted above those investors who are able to satisfy the wholesale client test are the investors most able to obtain their own financial advice before investing in wholesale products. Therefore, the focus should be on encouraging those investors to seek financial advice rather than penalising and restricting the entire financial services industry in an effort to protect those which have the means of protecting themselves.

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

No, it is our view that it is completely inappropriate to remove the distinction from the entire Act. The Government has continuously stated over the past few years that it wishes Australia to become a financial services hub. Removing the distinction from the entire Act would stifle financial services innovation and greatly reduce the number of financial product issuers. This would appear to be highly contradictory to the policy intention of growing the financial services industry in Australia.

6. 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?

No.

Is there any way that section 761GA can be amended to allay fears of licensees being exposed to legal liability while maintaining investor protection?

Yes, an introduction of a “safe harbour” style policy in this area would be a significant step forward and most likely increase the number of licensees who rely upon the test in section 761GA.

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

Yes, we believe the introduction of a “safe harbour” in the form of a statutory rule which would absolve a licensee of liability where they have acted according to a particular formula would be of great assistance.

7. Option 4 – Do nothing

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

Yes, as noted throughout this submission, we are yet to be satisfied there have been sufficient problems experienced through the Global Financial Crisis which warrant any changes to the existing wholesale client tests.

We recognise that local councils have had some issues; however, as noted above, the particular statutory bodies overseeing those local councils have already taken steps to resolve the particular issues faced by those investors. Therefore, we fail to see the need to implement anything further at a Commonwealth level. We believe the introduction of

an “objective” financial literacy test for financially literate sophisticated investors would be a positive step. We also consider that implementing an “objective” financial literacy test for complex derivative-based products would be beneficial.

Are the monetary threshold limits still relevant?

Yes, however, if the Government were minded to increase any of the monetary threshold limits then, in our view, the only limit which should be increased is the product value threshold.

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

No, see our comments above; we do not believe they should be increased. However, if the Government does decide to increase the product value threshold then we believe the Government should undertake further research to determine what impact any proposed increase in the threshold would have on the financial services industry.

8. Further considerations

We do not have any comments with respect to the professional investor definition other than to note, in our view, we think the current definition is still valid.

9. Superannuation funds as retail clients

We have had correspondence with ASIC in relation to whether or not section 761G and section 761GA applies to financial services and products made available to the trustee of a superannuation fund (other than superannuation products).

Schedule one to this submission contains the submission we made to ASIC on this point (which contains all of our reasoning and views).

We welcome the Government’s interest in providing clarification on this point and look forward to receiving some clarification on this issue.

10. Conclusion

Please contact Chris Mee or Brendan Ivers from McMahon Clarke Legal on 07 3239 2957 to discuss any aspect of this submission.

Schedule 1—ASIC submission and response

Australian Direct Property Investment Association

Submission—superannuation funds as wholesale clients or sophisticated investors

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1. About ADPIA

The Australian Direct Property Investment Association (ADPIA), established in 1999, is the peak industry body representing the $32 billion direct property investment industry.

ADPIA is a non-profit organisation and with a key objective to assist Australians to confidently invest in a collective way in property to build their wealth and achieve financial security through managed property investments such as property syndicates and unlisted property funds.

ADPIA also aims to:

- provide leadership in the direct property investment sector;
- represent the interests of members to the government, media and the public;
- provide education to members and the public;
- build consumer awareness of and confidence in direct property investment;
- assist in the professional growth of its members;
- produce and distribute effective research material to members and the public; and
- promote integrity and best practice standards amongst the industry.

ADPIA members manage property predominantly in the retail, industrial and office property sectors. Our members also offer investment vehicles holding property in the retirement, medical, childcare, residential and leisure sectors. This industry reflects the Australian love for property. To most people this means buying another house or unit. However, there are a wide range of property investment options available, many of which may provide superior returns when compared to residential property. Property funds and other direct property investments allow you to safely and profitably invest in a wide variety of property types - for moderate investment sums.

The ADPIA membership consists of three tranches - Originator Members, Adviser Members and Affiliate Members.

- Originator Members are property fund managers that offer direct property investments to the public.
- Adviser Members offer services to the Originator Members and include research houses, custodians, legal advisers, accounting professionals, property financiers,

quantity surveyors and other service providers to the property funds management industry.

- Affiliate Members are those who will become Originator Members within two years, but do not yet hold an Australian financial services licence.

ADPIA's current membership numbers approximately 77, across Australia.

More information in relation to ADPIA, its members and direct property investments can be found at www.adpia.com.au or on request from mail@adpia.com.au.

2. Objective

This submission relates to the application of the wholesale client[1] and sophisticated investor[2] tests in the *Corporations Act 2001* (Act) to trustees of superannuation funds.

The objectives of this submission are to seek confirmation from ASIC of the following:

(a) Trustees of superannuation funds with net assets of less than $10 million (small superannuation funds) that satisfy the wholesale client tests in the Act may be treated as wholesale clients in relation to the issue of interests in managed investment schemes.

(b) Trustees of superannuation funds that satisfy the sophisticated investor requirements in the Act may be treated as sophisticated investors in relation to the issue of interests in managed investment schemes.

References to chapters, parts, sections and subsections in this submission are to chapters, parts, sections and subsections of the Act.

3. Trustees of small superannuation funds as wholesale clients

3.1 Relevant provisions

The Act provides tests for determining whether a person is a retail client or a wholesale client.[3] The tests differ depending on the nature of the financial product or financial service that is being provided.

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[1] Subsection 761G(7)

[2] Section 761GA

[3] Subsections 761(5), (6) and (7)

The following provisions are relevant in determining whether trustees of small superannuation funds can be wholesale clients:

(a) Subsection 761G(1) provides that a financial product or a financial service is provided to a person as a retail client unless subsections 761G(5), 761G(6) or 761G(7) provide otherwise.

(b) Subsection 761G(6) provides as follows (emphasis added):

"***Superannuation and RSA products***

For the purposes of this Chapter:

(a) If a financial product provided to a person is a superannuation product or an RSA product, the product is provided to the person as a retail client; and

(aa) however, if a trustee of a pooled superannuation trust (within the meaning of the Superannuation Industry (Supervision) Act 1993) provides a financial product that is an interest in the trust to a person covered by subparagraph (c)(i), the product is not provided to the person as a retail client; and

(b) if a financial service (other than the provision of a financial product) provided to a person who is not covered by subparagraph (c)(i) or (ii) ***relates to a superannuation product*** *or an RSA product, the service is provided to the person as a retail client; and*

(c) *if a financial service (other than the provision of a financial product) provided to a person who is:*

(i) the trustee of a superannuation fund, an approved deposit fund, a pooled superannuation trust or a public sector superannuation scheme (within the meaning of the Superannuation Industry (Supervision) Act 1993) that has net assets of at least $10 million; or

(ii) an RSA provider (within the meaning of the Retirement Savings Account Act 1997);

relates to a superannuation product or an RSA product, that does not constitute the provision of a financial service to the person as a retail client."

(c) The opening words of subsection 761G(7) provide as follows (emphasis added):

"***Other kinds of financial product***

For the purposes of this Chapter, if a financial product is not, or a financial service provided to a person ***does not relate to,*** *a general insurance product,* ***a superannuation product*** *or an RSA product, the product or service is provided to the person as a retail client unless one or more of the following paragraphs apply....*".

3.2 ADPIA's view

ADPIA's view is that trustees of small superannuation funds can be considered wholesale clients if they satisfy one of the wholesale client tests in subsection 761G(7).

Subsection 761G(6)(b), and the carve-out at the beginning of subsection 761G(7), which operate such that the provision of certain services to trustees of superannuation funds are always provided on a retail client basis, are only intended to apply where—

(a) the financial product is a superannuation product (i.e., an interest in a superannuation fund[4]), or

(b) the financial service being provided actually "relates to" a person's investment in a superannuation product (i.e., a superannuation fund).

For example, advice provided to a person in relation to the person’s choice of superannuation fund relates to a superannuation product and therefore, this service would always be provided to the person as a retail client. Other examples may be advice provided to a person regarding their ability to switch funds; or advice in relation to an insurance product, which itself forms part of or is associated with a superannuation fund.

The issue of a managed investment product to the trustee of a superannuation fund is not a superannuation product and does not "relate to" an interest in the

[4] Under subsections 761A and 764A(1)(g), "superannuation product" means a "superannuation interest" within the meaning of the *Superannuation Industry (Supervision) Act 1993* (SIS Act). A superannuation interest is a beneficial interest in a superannuation entity (section 10 of the SIS Act). A superannuation entity is a regulated superannuation fund, an approved deposit fund, or a pooled superannuation trust (section 10 of the SIS Act).

actual superannuation fund itself. Therefore, the provision of this service is not caught by subsection 761G(6)(b) and may be provided to the trustee of the superannuation fund on a wholesale client basis if that trustee satisfies one of the wholesale client tests in subsection 761G(7).

However, this view is contrary to ASIC's position which is that financial services provided to a trustee of a superannuation fund will always be provided to the trustee as a "retail client", unless the fund has net assets of at least $10 million.[5]

The application of ASIC's view is that, because of subsection 761G(6)(b), whenever a financial service is provided to a trustee of a superannuation fund in relation to the fund it administers, that service will always "*relate to*" a "*superannuation product*" and therefore (unless the fund has net assets of at least $10 million), the service will be provided to the trustee (and therefore to the fund) as a retail client.

On this view, subsection 761G(7) can never apply to a small superannuation fund, which means such a fund cannot take advantage of the exclusions within subsections 761G(7)(a) and (c) to achieve wholesale client status.

For ASIC's view to be legally correct, then any financial service provided to a trustee of a superannuation fund must be able to be construed as a service which "*relates to*" an interest in a superannuation fund. This requires a very broad view of the phrase "*relates to a superannuation product*", which is not consistent with the subsections themselves or the Explanatory Memorandum (EM) to the original *Financial Services Reform Bill 2001*.

3.3 Support for ADPIA's view

The following support ADPIA's view that the phrase "relates to" requires a narrower interpretation than that adopted by ASIC.

(a) The operation of subsections 761G(6) and 761G(7)

If ASIC's wide view of the phrase "relates to" is correct, then this would mean there is a gap in the operation of subsections 761G(6) and 761G(7), which has the effect that all **issues** of financial products (except for the issue of interests in pooled superannuation funds[6]) to superannuation funds

[5] ASIC's response to QFS 150—When financial services are provided to a trustee of a superannuation fund, are they provided to a retail client?

[6] Subsection 761G(6)(aa)

are always issues to those funds as retail clients, even where a fund may have net assets of at least $10 million.

The reason for this is subsection 761G(6)(c) does **not** apply to the “provision of a financial product” (except for an interest in a pooled superannuation fund) to a superannuation fund with net assets of $10 million or more. Subsection 761G(6)(c) only applies to other financial services and the provision of interests in a pooled superannuation fund. Subsection 761G(6)(a) applies to the provision of a financial product but the carve outs in 761G(6)(c) do not apply to that subsection.

If none of the wholesale tests in subsection 761G(7) are able to be applied to a superannuation fund when it acquires a financial product (e.g., units in a managed investment scheme), then there are **no** tests available under which the fund can receive wholesale status for the acquisition, **even where** the fund has net assets of $10 million or more.

This would mean that even a superannuation fund with net assets of over $10 million can only be a wholesale client in the context of receiving financial product advice or acquiring an interest in a pooled superannuation fund. Such a fund would always be a retail client in the context of other financial product acquisitions. This cannot be the intention of the legislature. The better view is ADPIA's view— that subsections 761G(6) and 761G(7) are not intended to have the effect that **all** financial services provided to trustees of small superannuation funds will be provided to those trustees as retail clients.

(b) The EM to the original *Financial Services Reform Bill 2001*

The EM does not provide a definitive answer to whether the phrase "relates to a superannuation product" requires a broad or narrow interpretation.

However, explanations in the EM point towards an intention that persons acquiring an interest in a superannuation fund (or retirement savings account) should be afforded retail client protection, as opposed to an intention that all trustees of small superannuation funds should be treated as retail clients when services are provided to them.

Paragraph 6.17 of the EM provides as follows (emphasis added):

“*Proposed subsection 761G(6) provides that **where a person acquires a superannuation product** or a retirement savings account (RSA) product**, or a financial service related to one of these**, the person acquires the*

product as a retail client. This test is not restricted to individuals and small businesses, but applies to all persons, regardless of their circumstances. This subsection was included due to the difficulty in drawing any meaningful distinction based on product value between retail and wholesale clients in relation to superannuation and RSAs, given the large amounts frequently involved in superannuation payouts, for example."

Paragraph 6.19 of the EM then goes on to say as follows :

"*The test in proposed paragraph 761G(7)(a) is based on the assumption that persons who can afford to acquire financial products or services with a value above the prescribed amount do not require protection as retail clients, as they may be presumed to have either adequate knowledge of the product or service, or the means to acquire appropriate advice.*"

Under the heading "Superannuation products", paragraph 6.76 of the EM provides as follows:

"*The [FSR] regime will apply to "superannuation interests" within the meaning of the SIS Act.*"

The paragraphs set out above indicate the intention of the legislature was that all persons acquiring investments in superannuation funds, or services relating to **those** investments, would be treated as retail clients. There is no indication that retail client treatment should be extended to apply in situations where financial products and services that do not specifically relate to a superannuation member's interest in the fund are provided to trustees of superannuation funds (e.g., when a trustee is issued a managed investment product as a result of making an investment on behalf of the superannuation fund).

(c) Judicial consideration of the phrase "*relates to*"

Generally the word "relates", or the phrases "in relation to" or "relates to" are expressions of wide import. However, the meaning of the phrase "relates to" depends on the context in which it is used within the Act[7].

[7] *O'Grady v North Queensland Co Ltd* (1990) 169 CLR 356 at 367, 373-374; applied in *North Sydney Council v Ligon 302 Pty Limited* (1996) 185 CLR 470).

The High Court of Australia in *O'Grady v North Queensland Co Ltd*[8] when considering the interpretation of the words "in relation to" in the *Mining Act 1968 (Qld)* stated as follows:

"*The words 'in relation to' read out of context are wide enough to cover every conceivable connexion. But those words should not be read out of context which in this case is provided by the Mining Act 1968 (Q). What is required is a relevant relationship, having regard to the scope of the Act.*"[9]

In O'Grady the High Court also stated that when interpreting the words "in relation to" what is required is "*something more than a coincidental or mere connexion — something in the nature of a relevant relationship — is necessary.*"[10]

As noted above, the context of subsections 761G(6) and 761G(7) is provided by reference to the term "superannuation product". When read in the context of the meaning of "superannuation product", the term "relates to" in the subsections applies such that the relevant relationship extends only to a person's actual investment in a superannuation product.

(i) The term "relates to a superannuation product" does not extend to all financial services (e.g., the issue of units in a managed investment scheme) provided to the trustee of a superannuation fund. Subsections 761G(6) and 761G(7) are designed to protect the individual making the investment in the superannuation product. This is the relevant relationship. For the purposes of these subsections, a relevant relationship is not created when a licensee provides a financial service to the trustee of a superannuation fund. Such a service does not relate to an investment in the superannuation product.

(d) Nonsensical results

If ASIC's wide view of the phrase "relates to" is correct, then this would lead to nonsensical results in other applications of the wholesale client test.

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[8] (1990) 169 CLR

[9] *O'Grady v North Queensland Co Ltd* (1990) CLR 356 at 367 per Dawson J

[10] *Ibid*

One example of this is in the application of the wholesale client test in subsection 761(7)(G)(c)(i) as modified by regulation 7.6.02AC.

The effect of the modification in regulation 7.6.02AC is that in determining the net assets of a person for the purposes of the wholesale client test, the net assets of a company or trust controlled by the person may be included.

The modification of the wholesale client test coupled with the broad drafting of the term "control" in section 50AA means that there are circumstances where a person can include the assets of their self managed superannuation fund (as a trust which they control)[11], in the net assets test under subsection 761G(7)(c)(i) to avail themselves of wholesale client status when investing in a financial product or acquiring financial services.

This situation might arise where a self managed superannuation fund, which has more than $2.5 million in net assets, has a corporate trustee and two members, a husband and a wife. The corporate trustee acts at the behest of the husband and brings into force all of the husband's investment decisions for the superannuation fund and his decisions on how the superannuation fund will operate. In this scenario the husband would 'control' the self managed superannuation fund within the meaning of the Act and could therefore include the assets of the self managed superannuation fund when determining whether he is a wholesale client under section 761G(7)(c)(i). Meaning he could invest in financial products or be provided financial services as a wholesale client.

However, when the trustee of that same self managed superannuation fund invests in a financial product or is provided with a financial service, they can never be a wholesale client, unless (in relation to the provision of a financial service) the superannuation fund has net assets of at least $10 million.

[11] The Act does not define the term "trust". The Principles of the Law of Trusts defines a trust as "*an obligation enforceable in equity which rests on a person (the trustee) as owner of some specific property (the trust property) to deal with that property for the benefit of a certain person (the beneficiary) or persons, or for the advancement of certain purposes.*" Generally a superannuation fund will be created so that a person or body will hold property and make investment decisions on behalf of, and for the benefit of, members for the purpose of the provision of old age pensions. Consequently, a superannuation fund will generally be a trust.

Alternatively a situation might arise where a person is also the trustee of their self managed superannuation fund (which holds net assets of over $2.5 million but less than $10 million). If that person "controls" the self managed superannuation fund, then when the person invests in financial products or is provided with financial services on their own behalf they can do so as a wholesale client, by including the assets of their self managed superannuation fund in the wholesale client test calculation.

However, when that same person invests in a financial product or is provided with financial services in their capacity as trustee of their self managed superannuation fund, they cannot be a wholesale client.

These results, which flow from ASIC's view, are nonsensical and cannot have been the legislature's intention.

3.4 Submission

ADPIA requests that ASIC amend its response to QFS 150 to confirm subsections 761G(6) and (7) should be read to have the following effect:

(a) Subject to the exception in subsection 761G(6)(aa), where interests in a superannuation fund are provided to a person, the interests are taken to be provided to the person as a retail client.

(b) If financial product advice is provided to a person and the advice relates to an interest in a superannuation fund, then the advice is provided to the person as a retail client.

(c) The wholesale client tests in subsection 761G(7) can apply to a small superannuation fund, where the trustee of a small superannuation fund is acquiring a financial product for $500,000 or more (that is not an interest in a pooled superannuation fund) or is being provided a financial service in relation to a financial product valued at $500,000 or more, or where a fund itself meets the ($250,000) income or ($2.5 million) assets thresholds, so that the trustee of the superannuation fund can be treated as a wholesale client.

4. Superannuation funds as sophisticated investors

4.1 Relevant provision

The *Corporations Legislation Amendment (Simpler Regulatory System) Act 2007* (Cth) introduced section 761GA which enables any person (subject to specific

exemptions)[12] to access wholesale investor status in certain circumstances (i.e., where a licensee is satisfied a person has sufficient skills and experience to understand a financial product or service without receiving the level of disclosure otherwise afforded to retail clients). Section 761GA provides as follows (emphasis added):

"*Meaning of retail client—sophisticated investors*

For the purposes of this Chapter, a financial product, or a financial service in relation to a financial product, is not provided by one person to another person as a retail client if:

(a) the first person (the licensee) is a financial services licensee; and

(b) the financial product ***is not*** *a general insurance product,* ***a superannuation product*** *or an RSA product; and*

(c) the financial product or service is not provided for use in connection with a business; and

(d) the licensee is satisfied on reasonable grounds that the other person (the client) has previous experience in using financial services and investing in financial products that allows the client to assess:

(i) the merits of the product or service; and

(ii) the value of the product or service; and

(iii) the risks associated with holding the product; and

(iv) the client's own information needs; and

(v) the adequacy of the information given by the licensee and the product issuer; and

(e) the licensee gives the client before, or at the time when, the product or advice is provided a written statement of the licensee's reasons for being satisfied as to those matters; and

(f) the client signs a written acknowledgment before, or at the time when, the product or service is provided that:

(i) the licensee has not given the client a Product Disclosure Statement; and

[12] Subsections 761GA(b) and (c).

(ii) *the licensee has not given the client any other document that would be required to be given to the client under this Chapter if the product or service were provided to the client as a retail client; and*

(iii) *the licensee does not have any other obligation to the client under this Chapter that the licensee would have if the product or service were provided to the client as a retail client."*

4.2 Application of section 761GA to trustees of superannuation funds

A trustee of a superannuation fund is not excluded from qualifying as a sophisticated investor provided the trustee satisfies the requirements set out in subsection 761GA(d) and otherwise does not fall within the specific exemptions contained in subsections 761GA(b) and (c).

The exemptions in subsections 761GA(b) and (c) are as follows:

(a) The sophisticated investor test cannot be applied in circumstances where a "financial product" that is a "superannuation product" is "provided" by a licensee to a person.[13] Therefore, where a person becomes a member of a superannuation fund they will not be eligible for sophisticated investor status. This is the same as the position under subsection 761G(6) in relation to the retail and wholesale client tests as they apply to superannuation products. Clearly, if the product being acquired or the service relates to a product that is not a superannuation product (e.g. an interest in a managed investment scheme) then this subsection will not prevent the sophisticated investor test from being applied.

(b) The sophisticated investor test cannot be applied in circumstances where a financial product or service is provided for use "*in connection with a business*".[14]

The term "business" is not defined in the Act and the explanatory memorandum to the *Corporations Legislation Amendment (Simpler Regulatory System) Bill 2007* is silent on this issue. However, the explanatory memorandum to the *Financial Services Reform Bill 2001* which inserted subsection 761G(7)(b) (which uses the words "for use in

[13] Subsection 761GA(6).

[14] Subsection 761GA(c).

connection with a business that is not a small business") provides the following guidance on the legislative intent of the phrase (our emphasis):

"*The exception in proposed paragraph 761G(7)(b) results in 'big business' being treated as wholesale clients in relation to a financial product or service being provided for in connection with **that** business. There is no definition of 'big business' in the FSR Bill, instead it is defined negatively by reference to the definition of 'small business' in proposed subsection 761G(11)."*[15]

*"Therefore, small businesses receive protection as retail clients under the regime, provided the financial product or service is acquired for use in connection with **that** business."*[16]

The use of the phrase "in connection with **that** business" indicates the phrase "for use in connection with a business" is intended to be confined to use in **the** business acquiring the financial products or financial services. It is not intended to exclude financial products or financial services provided to a business where the financial products or financial services are not used by the acquiring business.

For example advice provided to a corporate trustee of a superannuation fund about professional indemnity insurance for the corporate trustee would be advice for use in connection with the trustee's superannuation business, and therefore excluded from section 761GA. Likewise financial product advice provided to a corporate trustee of a superannuation fund about a workers compensation insurance contract for its own employees entered into under state law would be provided for use in connection with the superannuation trustee's business and excluded from section 761GA.

However, issuing an interest in a managed investment scheme to a corporate trustee of a superannuation fund would not be captured by the exclusion in subsection 761GA(c) because the interest in the managed investment scheme would not be used in connection with the trustee's own business (which is the provision of trustee services). Rather the interest in the managed investment scheme is acquired on behalf of the members of the superannuation fund.

[15] Explanatory memorandum to the *Financial Services Reform Bill 2001*, paragraph 6.21.

[16] Explanatory memorandum to the *Financial Services Reform Bill 2001*, paragraph 6.22.

Subsection 761GA(c) would also not exclude a trustee of a self managed superannuation fund from being considered a sophisticated investor because the trustee of a self managed superannuation fund is not running a business but rather utilising a trust mechanism to invest their own superannuation funds by acquiring financial products or financial services.

4.3 Submission

ADPIA requests that ASIC confirm section 761GA should be read to have the following effect:

(a) A financial product (other than a general insurance product, a superannuation product or an RSA product) or financial service relating to a financial product provided to a trustee of a superannuation fund will be provided to the trustee as a wholesale client if—

(i) a licensee is satisfied on reasonable grounds that the trustee's previous experience in using financial services and investing in financial products allows them to assess the matters set out in subsection 761GA(d)

(ii) a licensee provides the trustee with their written reasons in accordance with subsection 761GA(e), and

(iii) the trustee signs a written acknowledgement in accordance with subsection 761GA(f).

(b) The exclusion in subsection 761GA(c) will only apply to a trustee of a superannuation fund where the financial product or financial service being acquired is being used in connection with the trustee's own business.

5. Conclusion

We look forward to working with ASIC to provide our members with clarification of ASIC's treatment of the matters raised in this submission. Please contact Andrew Shearer-Smith from McMahon Clarke Legal on 07 3239 2915 if you would like to discuss any aspect of this submission.