Stockbrokers Association of Australia
Incorporating SDIA

Wholesale and Retail Clients
Future of Financial Advice

Options Paper
January 2011

Submission to Treasury
28 February 2011

Executive Summary

The Stockbrokers Association of Australia makes the following comments about the *Options Paper*:

- the rationale of the proposals is not clear, and a wider review of the wholesale and retail definitions across the Corporations Act is recommended;
- there are serious concerns about the possibly detrimental effects of the proposals on capital raising in Australia, particularly in the small- and mid-cap sectors;
- the asset value test is complicated, and the real question is what truly represents a 'sophisticated investor';
- the product value test proposal to move to $1m may not achieve the aims of the review;
- the opportunity should be taken to revisit (or preferably remove) the superannuation trustee with assets of less than $10m and the small business tests; and
- there is no support for removing the wholesale/retail tests entirely, or for using the sophisticated investor test as the sole determinant.

We also note that there is support for a proposal to give ASIC the power to ban complex, dangerous products, such as is being proposed in the United Kingdom.

Before any of the options are adopted, more consultation will be necessary in order that our Members can analyse the effects on their businesses, and the likely benefits to clients.

Introduction

The Stockbrokers Association of Australia, the peak industry body representing institutional and retail stockbrokers and investment banks in Australia, is pleased to provide this submission to the Government in relation to its *Options Paper* (January 2011) on Wholesale and Retail Clients as part of its *Future of Financial Advice* program.

The Association's members have both retail and wholesale clients and have wide experience in the issues raised in the *Options Paper*, particularly how and where the boundaries should be drawn. Accordingly, our members are well place to comment on the *Options Paper*.

In this submission we would like to raise some General Points in relation to the wider review, before commenting in more detail on the four options set out in the *Options Paper*.

General Points

1. **Rationale for Review not Clear**
   - The review of Wholesale and Retail Client definitions of the *Corporations Act* was announced by the then Minister for Financial Services and Superannuation Hon Chris Bowen MP in April 2010[1]. This was part of the Government's response to the *Storm Inquiry*[2].
   - As noted in the *Options Paper*, the review was not one of the recommendations of the *Storm Inquiry*.
   - In terms of the rationale for reform therefore, the basis of this review is not clear. From the *Options Paper*, it appears that the main drivers for reform are that:
     - thresholds for the sophisticated investor tests may be out of date, and
     - certain Local Councils who were sold complex financial products such as collateralised debt obligations by Lehman Bros prior to the GFC may have had more protection if they were classified as Retail.
   - While it may be the case that certain thresholds may be in need of review, our Members would respectfully suggest that the experience of a small number of Local Councils through the GFC does not demonstrate a compelling case for law reform. Local Councils are significant enterprises and ought to have the resources available to obtain proper advice and protections without the need to be classified as Retail under the law.

2. **Risk to Capital Raising**
   - According to ASX results for the first half of FY2011, $39bn was raised by listed companies in the six months to 31 December 2010, $18.4bn of which was raised by secondary offers[3]. This latter amount would normally be raised through placements

[1] Hon Chris Bowen MP *The Future of Financial Advice* 26 April 2010
[2] Parliamentary Joint Committee on Corporations and Financial Services *Inquiry into financial products and services in Australia* November 2009
[3] ASX *2011 Half Year Report* page 3:
http://www.asxgroup.com.au/media/PDFs/20110217_asx_interim_report_hy11.pdf

to wholesale clients (including Sophisticated and Professional Investors) or rights issues.

- There is significant concern amongst stockbrokers that any widening of the definition of retail investor will substantially lessen the ability of companies, particularly those in the **small-cap** (up to $100m market capitalisation) and **mid-cap** ($100m to $500m) sectors, to raise capital.
- Small-Cap companies rely heavily on Sophisticated Investors to raise capital, either by direct subscriptions or by acting as sub-underwriters to our Members acting as underwriters[4]. There is little interest from Professional (institutional) Investors in this sector.
- Mid-Cap companies also rely on Sophisticated Investors to raise capital, but not to the same extent as Small Caps, because Professional Investors participate to some extent in capital raisings in this sector.
- Our Members, particularly those that act for companies in the Small Cap sector, are very concerned that any winding-back of the wholesale client categories, especially Sophisticated Investors, will lead to real problems in sourcing finance for listed companies.
- The potential loss of capital-raising opportunities for listed companies would also impact on investors. Investors who could no longer meet stricter wholesale requirements may miss out on the opportunity to participate in attractively priced share offers that may not be available to retail clients.
- The *Options Paper* concentrates on the financial services (advice) context of the wholesale and retail definitions. Given that '*consistency across the Corporations Act*' is one of the important factors for consideration in the review[5], more consideration needs to be given to any impact that changes to the wholesale and retail definitions may also have on capital raising in Australia.

3. **Wider Review needed**:
   - The current review of the definitions of Wholesale and Retail Clients in the *Corporations Act* should be an opportunity to examine ways to achieve a clearer, more standardised distinction between retail and wholesale clients in all the contexts of the *Act*, to ensure consistency of interpretation between brokers and financial advisers, and more certainty for clients.
   - Having just one month[6] to comment on a limited number of options proposed for consideration – especially coming as it did early in the year – may lead to the danger of other options being ignored and unintended consequences arising. For example, there could be more discussion about what constitutes a 'sophisticated investor', and the policy underpinnings to that determination. From there, the various contexts and tests could then be revisited. For instance, should an investor's

[4] Offers to Sophisticated Investors are usually made under section 708(8) (Sophisticated Investors) or section 708(10) (Persons assessed as sophisticated by financial services licensee)
[5] *Options Paper* page 15, paragraph 7.2
[6] The *Options Paper* was released by the Minister for Financial Services and Superannuation on 24 January 2011, for comment by 25 February 2011.

education or knowledge judged to an objective standard have greater use as a test, whilst retaining the use of a higher wealth / income based test? Is the product value test still appropriate in the retail context?

- The Paper canvasses a broad range of criteria and considerations for wholesale and retail clients[7], and draws international comparisons[8]. However, after a relatively large background of summary analysis, only a small number of options for Australia are presented.

Comments on the **Four Options** put forward in the Paper for consideration are set out below:

Option 1 – Update current definitions

There is some support for aspects of this option. However, support varies across the various 'sub-options'.

- **Asset value test**: Increasing the asset test, while sounding simple, will present logistical burdens and costs to participants. The real challenge is, looking at it from an investor protection point of view, whether this number represents a '**sophisticated investor**'. That said, there is some support for adopting something like the US model, reducing the $2.5m net asset test to $1m net investable assets (excluding superannuation and the family home, but including jointly held and controlled assets). However, more analysis of the impact on our members' businesses, and their clients, is necessary before more considered comment on such a proposal can be made.
- **Excluding Illiquids**: regarding the proposal to exclude Illiquids from the $2.5m asset test: superannuation by its nature is inherently illiquid, but there is some argument about whether the family home ought to be excluded. For example, leaving out the family home would exclude many people currently classified as wholesale, and could discriminate against those who choose to put money into their home, rather than renting or finding alternate accommodation. Again more impact analysis is required.
- **Product Value Test:** if it is proposed to increase the $500,000 minimum product value figure, it should be based on inflation. A doubling of the level to $1m may better reflect a sophisticated (or even professional) investor, but there would be draw-backs. By having to invest more funds in one product to meet the wholesale requirements, concentration risk for the individual investor would increase. In business terms, an increase to $1m will have a substantial effect on capital raising, wholesale product offerings, margin lending, and managed discretionary accounts for firms who do not deal with retail clients, meaning more impact analysis is required. In terms of systems, most firms now have integrated platforms that deal in all products and as such it is difficult to administer the regime if the definition is different across various products. If it is determined that a client is wholesale, then they should be wholesale for all financial products.

[7] *Options Paper* page 15 *7. Possible Options for a New Regime* which lists 10 different factors for consideration
[8] *Options Paper* page 11 15 *6. International Comparisons* which summarises measures in the US, UK, New Zealand, Hong Kong and Canada

- **Indexation of limits**: indexation would have the benefit of limits keeping up with inflation. However, given that it looks likely that the wholesale/retail tests will continue to have multiple options and/or combinations depending on the context (product value, client assets, etc), it needs to be acknowledged that systems, training and procedural changes consequent upon indexation will be a substantial cost and burden to the industry. Therefore, if indexation is introduced, it should be done no more frequently than every **5 years.** It should also be applied in a manner that results in round numbers, rather than just strictly applying the appropriate indexation rate to the current amounts. In this way, the amounts will reasonably keep pace with inflation, and industry's burdens will be minimized.
- **Client Opting-Up to wholesale**: while this may be of practical use for our members and their clients, it could raise liability problems unless the client makes a properly informed choice. It would be a concern, for example, if a wholesale client later argued that they ought to have been classified as retail, despite opting-up.
- **Introduce a 2 out of 3 test**: there is some support for this proposal, provided it does not significantly increase the category of retail clients. However, members are concerned about the additional costs and procedural burdens that will inevitably arise. The wholesale/retail test is already complicated, and as mentioned previously we believe a wider review of this area is justified. This 2 out of 3 aspect will only add to its complexity.
- **Complex Products**: regarding the proposal to have a product-based definition for complex products, see Option 4 below.
- **Superannuation Trustees with less than $10m net assets - Section 761G(6)[9]:** The treatment of superannuation trustees with less than $10m in assets has caused difficulties in practice since it was introduced in 2004. If the limit is increased then can we look at the super limit as well. As I understand it, for super the limit is $10m and this is where most of the issues lie from a participant perspective. We essentially have two separate models to administer for the one client when investing in a wholesale offering. Where a client is provided with a superannuation product or a Retirement Savings Account (RSA) product they will always be a retail client. This applies regardless of how a client might otherwise be categorised. Where a client is provided with a financial service (other than the provision of a financial product) which relates to a superannuation product or RSA product they will be a retail client unless they are:
  - the trustee of a superannuation fund, an approved deposit fund, a pooled superannuation trust or a public sector superannuation scheme with net assets of at least $10 million, or
  - a RSA provider.

  In ASIC *Frequently Asked Question* QFS150[10], ASIC states that trustees of Super funds with less than $10M in NTA ought to be treated as retail clients. It appears that ASIC is trying to extend the concept of a retail client to include a trustee of a superannuation fund to whom any financial product or service is provided, unless that particular fund has at least $10M in net assets. It has always appeared to our Members that ASIC's interpretation is wrong as it

[9] This matter – and the next point on the **small business test** - was first raised by the Association (then known as the Securities & Derivatives Industry Association) during the 2006/7 *FSR Refinements* review, but was not adopted in the 2007 amendments to the *Corporations Act*.

[10] This FAQ was originally issued on 25/11/04 and updated on 22/05/05.

extends the definition of retail client beyond the nexus of superannuation product or RSA product laid down in the legislation. The important thing to note is that the section relates to superannuation products and RSA products. It is also important to note that the fund itself is not the product. (Rather the product is the interest that the person attains when becoming a member of the fund.) ASIC have taken a very broad interpretation of the phrase 'relates to'. More specifically, they have taken the view that a financial service can relate to a superannuation product whenever financial services are provided to superannuation trustees, even if that advice or dealing concerns securities, managed investment schemes, basic deposit products etc and not superannuation products or RSA products. Accordingly ASIC is of the view that all superannuation trustees with fund assets of less than $10M must be treated as retail clients for all advisory and dealing services. There are differing legal views on the interpretation. We would submit that it ought to be clarified by amendments to the legislation, preferably to remove the special treatment of superannuation trustees, so the question reverts to the usual definitions of wholesale/retail in s761G, etc.

- **Small Business Test:** The small business test has caused difficulties in practice is of doubtful use. It is not clear why small businesses constitute a distinct class of investor requiring specific treatment; or why it is significant from a policy perspective whether a product is 'provided for use in connection with a business that is not a small business' (s761G(7)(b); or is 'provided for use in connection with a business' (s761G(7)(c). If this test is not removed from the law, its application should at least be limited significantly. In the context of offering products to which S761G applies (for example, derivatives or interests in a managed fund), how does one assess whether the relevant product is 'for use in connection with a small business'? In any case, why should this be relevant in determining whether a particular investor is 'wholesale' or not? The test turns on factors that will change regularly (e.g. number of employees in a seasonal business). It assumes (quite arbitrarily) that small businesses in non-manufacturing industries are 'smarter' than small businesses in manufacturing industries (in that manufacturing businesses remain small businesses until they have 100 employees, while other small businesses cease to be small businesses once they have 20 employees). Accordingly, the small business test should also be removed from the law.

Option 2 – remove distinction between retail and wholesale clients

This Option has no support. While firms with retail clients have the policies, systems, processes and procedures to cope with a world where all clients would be treated as retail, it would be a revolution for institutional firms. There is no policy, legal or regulatory justification for treating all wholesale clients as retail.

Option 3 – only use a sophisticated investor test as in section 761GA – the 'Subjective Test'

This option has no support.

While Brokers like to have the flexibility to be able to treat an investor as 'sophisticated' based on their own assessment of the investor's experience and circumstances, this category is not widely used. Its use is normally limited to the section 708(10) context of offers of securities without a prospectus (what used to be called 'excluded offers') rather than in the section 761GA financial services context.

Moreover, the use of the subjective test as the sole determinant of category of investor may lead to an uneven business environment, where firms which take a conservative approach would not be able to compete with firms with a higher risk appetite that may prey on investors. This form of 'regulatory arbitrage' should not be facilitated.

Option 4 – do nothing

There is some support for this option.

As mentioned above[11], the *Storm Inquiry* and the Government's response appear to have been brought about by a limited amount of trading by two firms for clients in complex products using highly leveraged strategies. While the overall FOFA review should lead to improvements for retail investors in Australia, it needs to be kept in perspective. If the heart of the problem was retail clients dealing in complex products using high levels of leverage, then perhaps that activity should itself be limited or banned. Margin Lending is now regulated as a financial product under the *Corporations Act*, with accompanying protections for retail clients now in effect. Perhaps the focus should turn to the 'Products Test' and banning complex products like CDO's, CFD's and Margin FX from being marketed to Retail Investors, or at least giving ASIC the power to declare them 'complex'.[12] Such a shift in focus would ensure that there are no unintended consequences, like restricting the capital-raising market where no intervention is required.

Thank-you once again for the opportunity to comment on these important reforms. Thank-you also for the opportunity to discuss these reforms with Treasury staff, who have participated in member forums. Should you require further information, please contact Doug Clark, Policy Executive dclark@stockbrokers.org.au.

STOCKBROKERS ASSOCIATION OF AUSTRALIA
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[11] See page 1 above, *1. Rationale for Review not Clear*
[12] This is similar to the approach taken in the United States. The United Kingdom is now considering a radical new approach, with new and intrusive powers for the authorities to intervene to prevent major consumer losses from product offerings. See, Financial Services Authority *Discussion Paper 11/1: Product Intervention* http://www.fsa.gov.uk/pubs/discussion/dp11_01.pdf