



**CHARTERED SECRETARIES  
AUSTRALIA**

*Leaders in governance*

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Future of Financial Advice  
Department of Treasury  
Langton Crescent  
CANBERRA ACT 2600

By email: [futureofadvice@treasury.gov.au](mailto:futureofadvice@treasury.gov.au)

***Wholesale and Retail Clients — Future of Financial Advice***

Chartered Secretaries Australia (CSA) is the independent leader in governance, risk and compliance. As the peak professional body delivering accredited education and the most practical and authoritative training and information in the field, we are focused on improving organisational performance and transparency.

Our Members are all involved in governance, corporate administration and compliance with the Corporations Act (the Act). Our Members work in both public listed and public unlisted companies, as well as in private companies. We have drawn on their experience in the formulation of each submission on the matters contained in the options paper: *Wholesale and Retail Clients — Future of Financial Advice* (the options paper).

We welcome the opportunity to comment on the options paper.

***General comments***

CSA Members are of the view that the terms 'retail' and 'wholesale' are not problematic in themselves, and do not recommend that the terms change. CSA is of the view that there are two different investment markets and that these should continue to be recognised. However, CSA recommends that the process of providing a risk management framework for retail clients should sit at the heart of any reform of how clients make financial decisions.

CSA strongly concurs that the current definition of the distinction between retail and wholesale clients has failed to uphold the spirit and intent of the legislation. CSA notes that having power over large sums of money does not, in itself, bestow financial literacy. CSA agrees that all clients could be presumed to be retail but should be able to upgrade to wholesale, and that such an upgrade would involve careful consideration of the risks involved in any particular investment, rather than meeting a wealth holding test. Our proposals in relation to this are set out on the following pages.

One issue that CSA believes should be raised is that the options paper refers extensively to investment decisions taken by local councils prior to the global financial crisis (GFC). However, CSA is of the view that any such reference is irrelevant to the issues under discussion. Local councils were shown to have no, or deficient proper governance requirements in place to facilitate an appropriate investment decision process. In effect, this meant that relatively low-

ranking council employees could commit the council to substantial investments without appropriate and qualified oversight. The apparent failure of governance frameworks within local councils has no bearing on any proposed reforms to the distinction between retail and wholesale clients and should not influence any decisions about reform.

### ***Option 1: Retain and update the current system***

CSA supports the retention of a distinction between retail and wholesale clients but agrees that the current definitions are not helpful. A person could borrow \$500,000 due to having sufficient equity in their house, but not be sophisticated as an investor. In other instances, people have participated in demutualisations or benefited from inheritance and now hold shares well in excess of \$500,000 yet do not have a sophisticated financial understanding.

However, CSA does not support the possible mechanisms to update the current system as they are set out in the options paper. CSA supports utilisation of some of the mechanisms set out in the options paper but recommends that they sit within a risk management framework as a more viable approach to reform.

Our reasons for recommending a different approach are that:

- updating product thresholds retains the current difficulties attached to the framework for assessing if an investor is retail or wholesale, as such an approach is still based on access to a level of wealth holdings, regardless of the sophistication of the investor. CSA is of the view that wealth is not an accurate proxy for financial literacy
- introducing an index mechanism continues the use of wealth holdings as the definitional threshold, despite the reality that access to wealth does not of itself provide for sophisticated investment decisions.

**CSA recommends** below an alternative threshold mechanism which avoids the issues raised. The alternative threshold mechanism amends the deeming process, excludes illiquid assets, and makes recommendations that change how the mechanism is to be applied.

#### ***CSA recommendation***

CSA supports amending the deeming process but believes it should be the reverse of that proposed in the options paper, that is, it should be based on an opt-out decision rather than the proposal put forward which is an opt-in scenario.

All investors would be deemed to be retail investors unless they opt out of this definition. The opt-out decision would not be a simple matter of ticking a box on a form, but would involve real consideration of the risks involved in deeming an investor to be wholesale.

CSA recommends that the deeming process could operate by clarifying that both the investor and their financial adviser must consider the impact on the investor's overall capital should the investment be lost. That is, it embeds a risk management process into the decision. While it would not prevent bad decision making (no law can prevent bad decision making) or fraud, it can provide signposts to investors to consider the risks of an investment. Financial thresholds could still operate, and illiquid assets could be excluded.

This definition could also address the issue where an investor does not have a financial adviser. Unless they are a 'professional investor' as defined, the test of being identified as a wholesale investor would apply. The individual would have to consider similar deeming barriers and recognition that ASIC has identified the product as a 'complex product' (see our comments later on our recommendation that ASIC identify when a product is complex).

CSA recommends that the deeming process should operate on the following principles:

- if the amount to be invested is above a percentage of the investor's capital (for example, 30 per cent), the investor is automatically deemed to be a retail investor
- should the investor wish to proceed to invest more than 30 per cent of their capital in the investment, the adviser must consider the allocation of the investment and provide advice on the potential impact on the client's capital should the investment fail
- both income and assets thresholds would need to be met (a net test) in a net asset wealth threshold test
- the illiquid assets of a home and superannuation would be excluded from the calculation of the net asset wealth threshold test
- the financial adviser is held liable if they have deemed an investor to be wholesale and cannot demonstrate that, at the time of providing the advice, they took adequate due diligence to ascertain that the investor understood the financial product and the risks attached to the investment, particularly the potential loss of original capital. The adviser should be bound to provide signed certification disclosing a proper basis to found due diligence.

The provision could operate in similar fashion to the provision of bank guarantees. At present, if a person offers a bank a guarantee, it is the bank that must show that the person understands what such a guarantee involves. An opt-out deeming process in turn ensures that the financial adviser:

- becomes familiar with the needs of the investor
- makes intelligent and informed decisions concerning the financial literacy of the investor
- develops the financial literacy of the investor which in turn further facilitates the relationship and the capacity of the investor to make sophisticated investment decisions
- takes responsibility, along with the investor, for any failure of decision making as to the client's financial literacy.

CSA notes that an amended deeming process as recommended manages to ensure that:

- unsophisticated investors stop to consider the implications of their decision, while not requiring them to step forward to acknowledge that they do not understand the financial decision, which currently unsophisticated investors are often loath to do
- sophisticated investors can acknowledge their financial literacy, which they would be only too happy to do.

That is, the opt-out deeming process is more empowering to the consumer.

### ***Introduce certain requirement for certain complex products***

CSA does not support introducing extra requirements for certain complex products, as this becomes a fraught exercise in drafting terms.

CSA recommends that, rather than providing for such requirement in the law, the Australian Securities & Investments Commission (ASIC) should be provided with the right to declare if a product is complex and requires higher thresholds.

The benefits of having ASIC declare if a financial product is complex are that:

- if ASIC declares a financial product to be complex, it provides the necessary circuit breaker to ensure that financial advisers develop an understanding of the product, so that they can genuinely assist their clients to either also understand it or decline from investing in it due to its complexity
- as a financial product becomes more familiar to the market, ASIC has the capacity to declare that it is no longer complex
- it allows for a gestation period in which financial advisers can develop understanding of new products while not stifling innovation

- hardwiring definitions of complex financial products into the law is difficult and limiting
- investors in complex products would not have access to the Financial Ombudsman Services (FOS) in the event of any disputes.

***Repeal the ‘sophisticated investor’ test***

CSA supports repealing the sophisticated investor test. The definition is problematic, lacking clarity and distinction between retail and wholesale clients.

***Option 2: Remove the distinction between wholesale and retail clients***

CSA does not support removing the distinction between wholesale and retail clients.

As noted above, CSA supports the retention of a distinction between retail and wholesale clients but agrees that the current definitions fail in intent. CSA is of the view that there are two different investment markets and that these should continue to be recognised.

CSA refers to its recommendations above for a reversed deeming process for applying the distinction between wholesale and retail clients that is not only dependent on wealth holdings and that is based on sound risk management principles.

Furthermore, CSA notes that if the distinction between wholesale and retail clients is removed, there may be a cost to Australian Financial Services licence holders. Section 912B of the Act requires AFSL holders who provide financial services for retail clients to have a compensation arrangement for the benefit of those clients. The compensation arrangements can be either a professional indemnity insurance policy or another arrangement approved by ASIC. If all clients (other than professional investors) were to be regarded as retail clients then those AFSL holders who have a component of wholesale clients may need to increase the size of their compensation arrangements.

There is also the issue that if all investors are regarded as retail, the risk element in products is potentially reduced by the compensation arrangements, or perceived to be mitigated. There are two additional risks that could distort the market. First, the availability of compensation means issuers of products may redesign the specifications so they produce a lower return, because the risk to the client is less, although the risk of the product itself defaulting is the same. Second, insurers may alter their offering as a result of the changed risk dynamics. Allowing for investors to be deemed wholesale and ASIC to nominate products to be ‘complex’ maintains the risk/reward premise.

If all investors are regarded as retail, this will also provide access to the FOS for those who should be responsible for their own risk/investment decisions (currently retail clients have access to the FOS when they have a dispute with a financial services provider — there are limits in the FOS terms and conditions as to the amount of possible redress and the access to this free service — while professional investors go to the courts). The cost of providing for the increase in those that can take a complaint to the FOS may trigger an unacceptable increase in fees for licensees that are members of the FOS, which together may result in a spread of resources providing an unacceptable level of service and resolution of complaints.

***Option 3: Introduce a ‘sophisticated investor’ test as the sole way to distinguish between wholesale and retail clients***

CSA does not support the introduction of a ‘sophisticated investor’ test as the sole way to distinguish between wholesale and retail clients. The current definition is problematic and

lacking clarity and this should not be introduced as the means of distinguishing between retail and wholesale clients.

#### **Option 4: Do Nothing**

CSA does not support inaction.

CSA is of the view that the current definition of the distinction between retail and wholesale clients is not working, and that a test based on wealth holdings is insufficient to ensure that investors consider the risks of an investment. CSA is strongly of the view that reform is required.

#### **Conclusion**

CSA is of the view that the risk/reward ratio that is fundamental to investment should continue. While legislation cannot prevent investors from losing money because they do not understand what they are doing, it can reduce the risk of investors not understanding what they risk in undertaking an investment. If investors are asked to consider the risks of an investment, including the impact on their capital should it fail, investors are then making informed decisions concerning their investments.

In preparing this submission, CSA has drawn on the expertise of the members of our two national policy committees.

Yours sincerely

A handwritten signature in black ink, reading "Tim Sheehy". The signature is written in a cursive, flowing style.

Tim Sheehy  
CHIEF EXECUTIVE