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Does the wholesale investor test need to change?

Stockbrokers and Investment Advisers Association

DISCUSSION PAPER

Contents

Scrutiny of the wholesale investor test	3
Is there evidence of harm?	3
Calls for change	5
How is the test applied in practice?	6
What would be the impact of change?	9
Conclusion	11
Appendix	12



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Scrutiny of the wholesale investor test

Calls for change to the wholesale investor test from members of academia, the legal profession and the financial advice industry itself have increased in frequency over the past few years. The argument for change is based primarily on the fact that the monetary threshold tests have not been amended since they were introduced in 2002 and the impact of inflation, alongside the sustained boom in Australian home values in parts of the country, has seen the number who qualify as wholesale increase significantly.

Evidence-informed policy proposes that public policy decisions should be based on, or informed by, objective evidence. The implied contrast is with policymaking based on ideology, anecdotes and intuitions.

There is currently recognition that well-intentioned but ill-founded policy and regulation has had a deleterious impact on access to and affordability of financial advice over the past few years. The unintended negative consequences of those policy changes are now subject to consideration as to how best to ameliorate them, with recognition from both the Government and Opposition that a different approach is required. Given the significant implications for financial advisers and their clients should any change to the wholesale investor test be introduced, it is important that any call for change be supported by evidence.

This paper addresses the issues of:

- whether there is evidence of harm to support calls for change
- how the test is applied in practice
- existing regulatory protections for wholesale investors and the consequences for advisers and investors of a change in the test.

The appendix covers the background to the current form of the test and looks at international comparisons.

The aim is to facilitate an informed discussion about the wholesale investor test as two reviews in 2022 are seeking feedback on whether this test should change. The Government has issued *Quality of Advice Review – Draft Terms of Reference* for consultation (which closes on 4 February 2022). The draft Terms of Reference note that the Review will include examination of the processes through which investors are designated as sophisticated investors and wholesale clients, and whether the consent arrangements are working effectively. The Australian Law Reform Commission (ALRC) has also issued the *Interim Report A Financial Services Legislation ALRC Report 137* (November 2021) in which it also seeks feedback on proposals concerning the wholesale investor definitions (see page 5 for further detail). This consultation closes on 25 February 2022.

Is there evidence of harm?

A key issue that is discussed when calling for a change to the wholesale investor test is whether there is evidence of harm or a market failure. What is the problem that proposals for change are trying to solve?

Global financial crisis

Following the global financial crisis (GFC), Treasury issued a consultation paper¹ seeking feedback on whether the wholesale investor test should change, referencing

a well-publicised case involving local councils² that had invested in complex financial instruments such as collateralised debt obligations (CDOs) sold by Lehman Brothers.

Local councils suffering from large losses as a result of their investments in these high risk and complex financial instruments were held up as an example of a situation where investors should not have been classified as wholesale due to their lack of awareness of the risks

¹ Australian Government, The Treasury, *Wholesale and Retail Clients Future of Financial Advice: Options Paper*, January 2011

² *Lehman Brothers Asia Holdings Limited (in Liquidation) v City of Swan & Ors; Lehman Brothers Holdings Inc v City of Swan & Ors*¹¹



of investing in those products. However, the problems resulting from the investment decisions taken by local councils prior to the GFC were identified as resulting primarily from a failure of governance rather than from problems with the wholesale investor test. 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 Treasury paper also noted that ‘During the GFC, retail clients’ problems mainly occurred in relation to investments in listed CDOs (which retail clients could access), which suffered substantial losses in market value due to the impact of the GFC on the value of the underlying assets.’

Mayfair

In recent calls for change, reference is made to Mayfair 101 as evidence of the shortcomings of the current wholesale investor test.³

What was made clear in the case⁴ was that ‘red flags’ regarding the operation of the Mayfair group of companies had been raised well before ASIC brought proceedings. That is, concern was raised about the nature of Mayfair’s offer and its mass-marketing to a broad population rather than with the wholesale investor test.

While the view is expressed that it was the wholesale investor test that made investors vulnerable to misleading and deceptive conduct, the false, misleading and deceptive provisions of the Corporations Act apply irrespective of whether a product is offered to retail or wholesale investors. ASIC always had the power to deal with the companies’ misconduct. As ASIC Deputy Chair, Karen Chester stated ‘ASIC’s success in court...demonstrates firms need to do the right thing by their investors, even when they are wholesale investors.’⁵ Categorising a product as being for wholesale investors only, does not allow an issuer to make false, misleading and deceptive statements about that product.

The Mayfair 101 case constitutes an outlier, involving a ‘bad actor’ that abused the wholesale investor test. It is always challenging to see one case being used to justify regulatory reform when the vast majority of those subject

to the particular law are not involved in misconduct. The question needs to be asked if the law should change due to the misconduct of one ‘bad actor’ or whether the focus should be on ASIC’s response to misconduct.

Australian Financial Complaints Authority

The Australian Financial Complaints Authority (AFCA) has discretion to accept complaints from wholesale clients, although it was set up to deal with retail client complaints.

Notice should be made of Treasury’s review of AFCA⁶ which recommends that AFCA should look to more actively exercise its existing discretion to exclude wholesale complaints in appropriate circumstances and that if a complaint is lodged by an apparent wholesale client and AFCA has made sufficient enquiries to rule out that they have been incorrectly or inappropriately classified by the firm, AFCA should have the discretion to exclude the complaint. The report also recommended that AFCA should exclude complaints from sophisticated clients as a matter of course, unless there is evidence that they have been incorrectly or inappropriately classified.

Treasury’s recommendations suggests that it found evidence that the wholesale client complaints lodged with AFCA did not represent investor lack of understanding of the risk of investing in certain financial products only available to wholesale clients. That is, the recommendation suggests that wholesale clients are not being inappropriately classified. The government has accepted the recommendations of the Treasury review.

Financial Services Royal Commission

There was no consideration of wholesale client issues by the Hayne Royal Commission. The topic did not appear to come up during the public hearings and was not mentioned in either the interim or final report.

Lack of evidence of harm

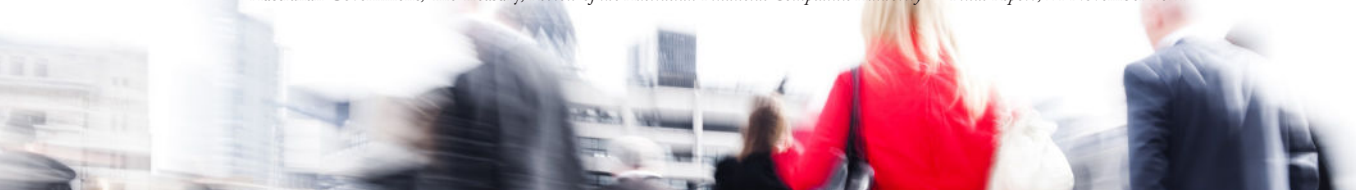
The GFC and its impact on local councils, which was primarily a governance issue, and the Mayfair 101 case, which was the misconduct of one ‘bad actor’ where the regulator already had the enforcement powers available to stop the conduct, are put forward as evidence for why the wholesale investor test needs to change.

³ The Mayfair companies promoted debenture products via their websites and online search platform advertisements to wholesale investors by stating that they were comparable to, and of similar risk profile to, bank term deposits. ASIC took action against the Mayfair companies and the court held the statements made in the advertisements by the Mayfair companies to be false, misleading or deceptive.

⁴ Australian Securities and Investments Commission v Mayfair Wealth Partners Pty Ltd (No 2) [2021] FCA 247

⁵ ASIC media release 21-055MR ‘ASIC succeeds in Court action against Mayfair 101 for misleading and deceptive advertising’, 23 March 2021.

⁶ Australian Government, The Treasury, *Review of the Australian Financial Complaints Authority — Final Report*, 24 November 2021



In light of this, calls for change to the wholesale investor test appear to be a solution looking for a problem. The calls appear to overlook other more pressing and practical issues currently facing the financial advice sector, such as a decline in the number of advisers, the increasing cost of advice and increased regulation adding to the cost of financial advice.

There is also no evidence that there is a market failure in relation to financial advice servicing the higher end of the income and asset distribution, particularly when such individuals have taken deliberate steps to opt out of the retail investor regime. Without evidence of harm or a market failure, are there grounds to introduce law reform?

Arguments in favour of change need to consider how the wholesale investor test is applied in practice, the context of the test and the impact that change would have on investors. These are important considerations when considering whether a policy change is justified.

Calls for change

Calls for change to the wholesale investor test have come from legal academics, members of the legal profession and some parts of the financial advice sector itself. Most of the criticisms focus on the individual wealth test (the monetary threshold test) and in particular the net asset threshold of \$2.5 million, as no longer being satisfactory as a proxy for financial knowledge.

The Financial Services Council (FSC) in its *White Paper on Financial Advice*, issued in October 2021, advocated for the definition of retail and wholesale client to be amended to ensure a greater proportion of financial advice consumers are considered to be retail clients and fall within the consumer protection framework. The FSC recommends:

- the retention of the distinction between wholesale and retail clients as well as an objective test
- increasing the threshold for the assets test from \$2.5 million to \$5 million in 2023 and thereafter indexing it to the Consumer Price Index
- retaining the other tests unchanged including the \$250,000 income threshold
- allowing existing wholesale clients that would be reclassified as retail as a result of the change to remain

wholesale if an election is made within a two-year transition period

- the government to undertake a review, following the completion of the FASEA transition period in 2026, whether an objective threshold is necessary or should be replaced by a provision allowing financial advisers to use their professional judgement to determine who is a wholesale client, as guided by the statutory best interests duty and code of ethics framework.

The paper's proposals are intended to reduce the regulatory burden on financial advisers, but the proposal to change the wholesale investor test could see many more advisers caught up in regulatory red tape.

In November 2021, the ALRC issued its interim report on Financial Services Legislation (ALRC Report 137). The report is open for consultation and invites views on the following aspects of the retail and wholesale client definition:

- what conditions or criteria should be considered in respect of the 'sophisticated investor' exception in s 761GA of the Corporations Act
- whether the asset and income test in section 761G (7) (c) and the product value test in section 761G (7) (a) should be removed
- whether the existing carve outs for general insurance products, superannuation products, RSA products and traditional trustee company services should be amended
- whether the definition of retail client should be amended in some other manner.

Professor Pamela Hanrahan, Professor of Commercial Law and Regulation at UNSW, who advised at the Hayne Royal Commission, has also recommended there is a 'clear and pressing need to update or radically alter the current definitions of retail and wholesale clients', citing Mayfair 101 as an example of the shortcomings of the status quo.⁷ Professor Hanrahan clarified that Mayfair 101 is an example of an investment firm with products seemingly designed for wholesale investors that were mass-marketed to a broader population and that, as was found in the case against Mayfair, this type of mass-marketing is misleading and deceptive if it is targeted at people who lack experience with complex illiquid investments.

Calls to amend the wholesale and retail definitions have also been reported widely in the media. Recent modelling conducted by Australian National University Associate

⁷ Tahn Sharpe, 'Hanrahan: Updating retail/wholesale client definitions "urgent"', 8 June 2021, *Professional Planner*.



Professor Ben Phillips, reported in the *Australian Financial Review* shows that the number of Australians who meet the wholesale investor wealth test has increased from 1.9 per cent of the population in 2002 to more than 16 per cent. The modelling has found 1.09 million households (or 3.25 million individuals) have at least \$2.5 million in assets or annual income exceeding \$250,000. In 2002, when the rule was implemented, just 104,000 households were eligible to be accredited as wholesale by an accountant.⁸

Advocates for change to the test raise the following issues:

- There is not always a positive correlation between wealth and financial literacy. For example, a person may exceed the individual wealth thresholds simply by the receipt of a windfall gain such as an inheritance or as a result of a lucky 'punt', for example, on assets such as cryptocurrency or speculative mining shares.
- With increased earnings, escalating property values, increased superannuation holdings and the effect of inflation, the individual wealth thresholds are becoming increasingly accessible to a range of clients who would not have been considered to be 'wealthy' in 2004.
- There is no mechanism for the periodic review of the product value or individual wealth dollar thresholds.
- Tests based on quantification of wealth exclude clients who have the requisite level of financial literacy, but not the requisite wealth (a good example being a compliant financial adviser).
- The eligibility tests are difficult to apply where assets are jointly owned (which commonly occurs in domestic relationships).
- There is a reluctance by AFSL holders to use the sophisticated investor test because of its subjective nature – with the resulting issues of conflict of interest, uncertainty and room for error in judgment which creates fear of later liability.

A different approach to a call for change has come from investment manager Geoff Wilson of Wilson Asset Management. Given that wealth is not always a proxy for financial literacy, he has stated that attention needs to be focused on the responsibility of the investor to confirm understanding of the financial products and risks in

order to self-select as a wholesale client. He has called for the sophisticated investor test to be abolished so that all consumers can access sharemarket capital raisings while replacing it with a financial literacy test for would-be unit-holders in managed funds.

How is the test applied in practice?

A wholesale investor qualification is not automatic and requires investors to opt in

There is an assumption in much of the recent commentary that a client can be treated as a wholesale client without either their knowledge or requiring their consent or by persuading them to become a wholesale client by virtue of a 'push' from the adviser.

Investors do not automatically become wholesale clients by virtue of their wealth or income; they must actively request this classification by obtaining a certificate from an accountant which must be renewed every two years. Unless they choose to become a wholesale investor and keep their certification up to date, investors who meet the income or asset threshold are subject to the same restrictions and protections as any other retail investor. Wholesale investors therefore take deliberate steps to opt out of the retail investor regime and consciously sign away protections applied to retail investors by seeking the wholesale certification. Importantly, they must obtain a certificate from a qualified accountant who is required to certify that the investor satisfies either or both of the two limbs of the wealth test. Qualified accountants are required to be members of recognised professional accounting bodies to meet the definition. As professionals, they are required to exercise their professional judgement and retain evidence in support of their certification.

The high-net-worth accountant's certificate has to be renewed every two years – it is not a 'set and forget' process. If the certificate expires and is not replaced, the client is no longer a wholesale client under the relevant section of the Corporations Act.

⁸ Aleks Vickovich, 'More than 3 million Aussies are now "sophisticated investors"', 11 October 2021, *Australian Financial Review*.



Is the monetary threshold test the only test applied?

There is more than one test in the legislation.

- **The product test:** the value of the financial product or financial service is greater than \$500,000.
- **Professional investor test:** this includes Australian Financial Services Licensees, Australian Prudential Regulation Authority regulated bodies, trustees of public superannuation funds, persons controlling at least \$10 million and the trustee of a superannuation fund which has net assets of at least \$10 million.
- **Small business test:** the consumer of the financial products or services is a business which is not a small business (that is, a non-manufacturing business with more than 20 employees or a manufacturing business with more than 100 employees).
- **Individual wealth test:** The monetary thresholds are set at \$2.5 million in net assets, or gross income for each of the last two financial years of at least \$250,000 per annum. The rationale behind these monetary thresholds is that investors meeting one of these criteria would be more capable of evaluating the financial products being offered without needing the protections of a regulated disclosure document such as a prospectus or product disclosure statement. ASIC notes that “Generally, people buying securities and other financial products must, under the Corporations Act 2001, be given a regulated disclosure document such as a prospectus or product disclosure statement. However, one of the exemptions in the Act is the offering of financial products to a person (either a natural person or a legal person) who is the subject of a current certificate from a qualified accountant certifying they have a prescribed net asset or gross income level.” The certificate is valid for two years.
- **Sophisticated investor test:** Investors defined as retail who are unable to access wholesale status and that for reasons such as experience or professional training may wish to be treated as wholesale investors to access wholesale investor status and wholesale-only products.

The individual wealth test is the one most popularly used to categorise clients as wholesale. Clients categorised as wholesale clients under this test are also referred to as high net worth (HNW) clients or (confusingly)

sophisticated investors. The confusion between these terms is explained in Appendix A.

A test that is based on an asset or income threshold is easy to apply and transparent to clients. The test is applied side-by-side with the product value test and professional investor test. The tests are well-used and the latter is often relied upon by institutional stockbrokers. Online brokers rely on these ‘black and white’ tests as they are a high volume, no advice business.

Licensees have obligations to certify in writing their reasons for being satisfied that a sophisticated client has previous experience in investing in securities and other financial products. The certification is to show that the client can assess the merits, value; and associated risks of the product and both their own information needs and the adequacy of the information provided by the licensee. The ‘sophisticated investor’ test is subjective and not many firms rely solely on it for this reason.

How are the tests used in practice?

In practice, licensees providing advice take a nuanced approach. They rely on the asset or income threshold test as an objective measure while also taking into account the sophistication and financial knowledge of the client. Licensees understand that a client’s asset level is not always a reliable indicator of financial knowledge or sophistication.

A client who is able to satisfy the asset threshold can be certified as a wholesale client, but this is often just the start of a journey, with the licensee going beyond the Corporations Act definition.

Some licensees have a matrix test that is used to evaluate whether a client who satisfies the asset or income threshold should be treated as wholesale once their investment experience and knowledge is taken into account. Another approach that is taken is to have a sophisticated investor panel that solicits details of the investor’s experience, which includes years of investing, qualifications and occupation and assesses whether they are to be categorised as wholesale. One example of an investor with a high level of financial literacy would be a director of a public company, given that they have a duty to be able to review and understand financial statements.

Licensees have in many instances developed robust processes for onboarding wholesale clients that ensure they are aware of the consequences of no longer being



categorised as retail, with clients required to sign and return an acknowledgement letter. Clients are advised as part of this process that they can ‘opt-in’ to retail if they decide they no longer want to be classified as wholesale. Importantly, under these processes, an adviser cannot simply categorise a client as wholesale — the application must be put before compliance personnel and a control process is applied. The licensee adds the client as a wholesale investor and the adviser cannot interfere in that process. Any queries are referred to compliance.

These processes form part of a licensee’s overall compliance and risk management framework and ensure that decisions about wholesale clients are made by the licensee, not the adviser, and there is appropriate supervision and monitoring of the client’s account and the risks involved.

Wholesale investors still have regulatory protections

Arguments for change do not reference the regulatory controls on the provision of advice to wholesale investors. The provision of ‘wholesale advice’ is not a regulatory ‘free for all’.

Wholesale investors can continue to receive general advice and execution-only services and ask for personal advice under contract with their adviser.

Wholesale investors still have protections under general law, the Market Integrity Rules and other provisions of the Corporations Act, specifically:

- the general obligations under section 912A of the Corporations Act that, amongst other things, require financial services licensees to provide financial services ‘efficiently, honestly and fairly’, manage conflicts of interest, comply with financial services laws and ensure their representatives do so as well and are adequately trained
- the consumer protection provisions of the Corporations Act including those dealing with misleading and deceptive conduct, unconscionable conduct, representations and warranties
- the common law fiduciary duty to act in the best interest of clients.

While the Corporations Act only requires licensees providing advice to retail clients to be a member of the Australian Financial Complaints Authority Scheme (AFCA), the recent *Review of AFCA*⁹ undertaken by Treasury recommended that wholesale investor complaints should continue to be accepted by AFCA where there is evidence that the investors have been incorrectly or inappropriately classified. This provides an important safety net.

As has been previously noted, wholesale clients can always ‘opt back in’ to being categorised as retail if their circumstances change.

Increasing knowledge and education of investors

Investor education has improved significantly since the original monetary thresholds were put in place. Clients are increasingly sophisticated.

Investors have access to more information about financial products and investing than when the test was introduced and can access that information in different ways.

Investors have access to information online via newsletters, chat rooms and investor forums. Listed entities now offer more information on their investor webpages, including webcasts of their AGMs. Regulatory changes resulting from COVID-19 lockdowns meant that listed entities held virtual AGMs enabling many investors to attend these events for the first time.

The Australian Shareholders Association provides investor forums, education days, newsletters and webinars and it and the Australian Investors Association each holds an annual investor conference. Investors are also able to attend investor forums arranged by organisations such as the ASX, which also offers online courses in shares, options and ETFs, as well as the sharemarket game so that investors can learn how the sharemarket works.

There has also been an increase of financial education and advice content on social media apps, although ‘influencers’ and money experts alike have urged new investors to be cautious about the financial content available.

⁹ Australian Government, The Treasury, *Review of the Australian Financial Complaints Authority — Final Report*, 24 November 2021



What would be the impact of change?

The client's perspective

According to the *ASX Investor Study 2020* close to nine million adult Australians hold investments outside their superannuation and primary dwelling with more than half investing in direct shares.

It is important to note that support for a change to the asset threshold is not originating from clients. That is, the calls for change are not coming from consumers.

The calls for change also do not consider the benefits that clients would forgo if they were reclassified from wholesale to retail as a result of such a change. Clients ask to be categorised as wholesale, wanting access to the additional investment opportunities available to this cohort. Evidence that licensees are 'pushing' clients into becoming wholesale has not been put forward. Clients would need to be surveyed to assess whether licensees are responding to client demand.

Commentators have argued that the level of securities fraud in Australia is at the lower end of the global experience. Wholesale investors still get the benefit of 'strong regulation, active regulators, vocal institutional investors and a very attentive media that exposes securities fraud long before it becomes endemic'.¹⁰ Evidence that the monetary thresholds are being systematically 'gamed' has not been put forward.

Any change to the wholesale client monetary thresholds would have a significant impact on clients, as many would no longer meet the test should it be amended. Given that clients seek access to wholesale client opportunities, licensees have structured their business to accommodate client demand. Businesses have relied on the existing model and advisers and clients have built their investing strategy on the current model.

In the wholesale advice sector, the relationship between adviser and client is often closely fostered by the adviser and is based on trust developed over a number of years. Changes to the test that re-classify clients may result in them losing access to their adviser of choice or force them to sell down their holdings. Any change would disadvantage a significant cohort of Australian investors who have not been consulted on their views of whether such a change is welcomed by them. With

business models relying on the definitions in structuring their businesses to meet client demand, change will bring disruption and attendant costs associated with implementing change. These impacts would not be uniform across the financial services industry, with some businesses and some clients being much more affected than others.

The financial advice sector has been subject to ongoing significant regulatory reform over a number of years. If the definitions are changed, consideration needs to be given to the impact on some businesses which have already moved away from advice to retail clients, as they could become unviable as the pool of potential clients shrinks. This in turn may exacerbate the decline in availability and affordability of financial advice.

Given that significant additional disruption and costs would be introduced into the system for both clients and licensees when to date no major benefits have been articulated, the rationale for changing the test is not clear, apart from concerns that outlier misconduct such as Mayfair 101 needs to be addressed. While concern is expressed that more and more clients are being provided with financial services without the benefit of the consumer protections that are obligatory for retail clients, as noted earlier, there is no clear evidence of harm.

Mayfair 101 does indeed represent misconduct, but it does not represent the experience of the vast majority of wholesale clients in Australia. An important issue to consider is that the Mayfair 101 case involved the direct issue of unlisted financial product. The clients did not receive advice on the product or apply for the product via their adviser or licensee. Changing the law to respond to the issues arising in the Mayfair case ignores the fact that clients who receive advice from their adviser or who deal through a financial services licensee and who were not the victims of the Mayfair case would be impacted negatively by any such change.

With Mayfair targeting wholesale investors who were avoiding seeking advice, one area that is worth consideration is the marketing of products aimed at wholesale investors. The firm's advertising was found by the Federal Court to have been deceptive and misleading

¹⁰ Hunt, Isuard & Friedlander, 'Arguing the case on investor protection', 24 October 2021, *Australian Financial Review*.



and inaccurately likened the products to term deposits. The advertising sought to divert investors who were interested in term deposits to invest in Mayfair products.

Professor Hanrahan has advised that the restriction of general advertising of wholesale offers should be contemplated, noting that such offers should not be made in the newspaper, particularly without warnings that are routinely required elsewhere, including in the UK.¹¹ Given that Mayfair undertook significant online advertising, including through google 'ad words' designed to divert investors interested in term deposits, restrictions on mass advertising would address concerns that firms are targeting investors avoiding advice and seeking income who meet the individual wealth thresholds.

Any calls for change concerning the wholesale investor test should involve the client's perspective.

Impact on investors outside of Sydney and Melbourne

Those wanting an increase to the \$2.5 million net asset threshold argue that it is easy for clients who own a house in Sydney or Melbourne to satisfy the test, even if they lack financial knowledge. While house prices have increased substantially in Australia's largest cities since the test was implemented and have seen a high rate of growth during the pandemic, house prices in Australia's regional and rural areas or in capital cities such as Perth and Adelaide have not reached the heights of those on the eastern seaboard.¹²

Increasing the threshold will have a disproportionate impact on clients who own real estate in those areas, excluding investors in the regions and a number of capital cities from accessing investment opportunities available to wholesale clients. A Sydney/Melbourne-centric view of Australian investors is narrow and does not take into account the perspectives of those living outside of these cities.

Clients in regional and rural areas and other capital cities would need to be consulted as to whether they support a change to the wholesale investor test.

Impact on other provisions of the Corporations Act

The wholesale client definition in Chapter 7 of the Corporations Act mirrors definitional provisions in

Chapter 6. Currently, offers of securities do not need disclosure to clients meeting the net asset or income threshold in section 708 (8) of the Corporations Act. Clients meeting the same net asset or gross income test in section 761 G (7) (c) can be classified as a wholesale client for the purposes of the provision of a financial product or service. This enables a client who has been classified as wholesale for the purposes of a capital raising, for example, to be classified as wholesale for the purposes of buying and selling financial products.

Inconsistency in definitions between chapters 6 and 7 of the Corporations Act would result in clients who are classified as wholesale for one purpose being ineligible to be treated as wholesale for another. This would be unworkable for stockbrokers and investment advisers as well as being confusing and frustrating for their clients.

Is there consumer benefit from proposed changes?

The main call for change relates to increasing the monetary thresholds for the individual wealth test.

Increasing the thresholds of the HNW investor test 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. Given that wealth is not always an accurate proxy for financial literacy, introducing a higher monetary threshold 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.

Changing the monetary threshold does not take into account the fact that many firms don't merely focus on a monetary threshold when deciding whether a client should be categorised as a wholesale investor, but also take into account qualitative measures.

Another change proposed is to apply indexing to the monetary thresholds. Applying an index to the asset threshold increases complexity and reduces transparency. Indexing adds uncertainty to determining whether a client meets the requirements or not and would not take into account financial market corrections.

There have been suggestions such as excluding the family home when determining if an investor meets the

¹¹ Tahn Sharpe, 'Calls mount for sophisticated investor rule review', 17 February 2020, *Professional Planner*

¹² The *Quarterly House Price Report* from online property marketplace, Domain released in January 2021 showed that Australian median house prices across all capital cities have increased to over the \$1 million mark.



monetary thresholds. Excluding the family home would simply advantage those clients who do not own a home and have invested in other assets while disadvantaging those who have decided to place their wealth in their family home. The regulatory focus should not be on the manner in which clients choose to invest their wealth. Furthermore, excluding the family home is likely to exclude a number of clients who are currently classified as wholesale and wish to remain categorised as such.

Despite investors not pushing for the test to be changed, a change to the test would potentially result in clients who were previously categorised as wholesale investors failing to meet the new definition, placing limits on their investment choice and causing unfairness. It may also close down access to investment opportunities and the individual market for capital.

Licensees have aligned their business model to the current regulatory framework, including the wholesale client definitions. Advisers who have adopted a wholesale-client-only business model are not required to have satisfied the educational and exam requirements that allows them to provide advice to retail clients. They would therefore find themselves treated as new entrants, subject not only to the education and exam requirements but also the Professional Year requirements and without a livelihood.

Furthermore, a change to the wholesale client definition will inevitably result in clients that were previously defined as wholesale being reclassified as retail. A wholesale-client-only adviser will be unable to continue to provide advice to those reclassified clients, essentially resulting in those retail clients losing their adviser. This may not be such a significant issue if retail client adviser numbers were increasing. Unfortunately, the reverse is the case. As of 3 December 2021, the net loss of advisers on the Financial Adviser Register for the 2021 year had surpassed 2,000 with the number of advisers at 18,574. In comparison, in 2018 there were 28,353 Financial Advisers.¹³ One outcome of the combination of a change in the wholesale client definition and the significant decline in the number of retail client advisers would be that reclassified clients would lose access to personal advice. At a time when the government, regulators and the financial advice industry concur that access to financial advice is now more difficult and there is a need

to work together to improve access, cutting a cohort of clients adrift would be counter-productive.

Consideration needs to be given as to whether there is a desire to remove all decision-making responsibility from investors.

Conclusion

This paper questions whether there has been a sufficient identification of harm to investors in recent calls to justify amendment of the wholesale investor test and whether the significant disruption to clients and advisers (and their businesses) that would arise from any change to the definitions can be justified in light of the impact it would have on access to and affordability of advice.

A key question is whether reference to outlier misconduct should be utilised to disrupt significant numbers of clients' investment strategies and licensees' business models. Misconduct needs to be investigated and enforcement action taken — ASIC already has the powers to do this. Yet recent calls for change take the view that a range of Australian investors should be excluded from accessing investment opportunities due to outlier misconduct, or the potential for outlier misconduct.

Another key question is whether the voice of the client has been sought. Before embarking on another round of regulatory reform, it would be appropriate to survey wholesale clients, qualitatively and quantitatively, to assess their views on whether they have concerns that they:

- have been inappropriately classified
- do not understand the risks of the financial products in which they invest
- are happy to be excluded from investing in certain financial products.

This paper has been issued to inform the current debate on whether the wholesale investor test should be changed, particularly in light of the two consultations taking place that are examining this issue. It raises a series of questions and it is hoped that all those interested in this issue will consider them.

¹³ 'Over 2k advisers have exited the industry this year', 3 December 2021, *Independent Financial Adviser*.



Appendix

Background

A distinction between retail and wholesale clients was inserted into the Corporations Act by the *Financial Services Reform Act 2001* developed in response to the recommendations of the Wallis Inquiry released in March 1997.

Motivation

The main motivation for drawing the distinction between retail and wholesale clients was to identify those considered in need of regulatory protection, as well as the desire to allow certain clients to participate in wholesale markets which tend to trade more complex products. Consumer protection provisions would only apply to retail clients as it was recognised that wholesale clients did not require the same level of protection, as they are better informed and better able to assess the risks involved in financial transactions. Wholesale investors are also better able to fend for themselves financially if a dispute arises or sustain the risk of loss.

Insurance and superannuation were treated differently, but investors in other financial products could be treated as wholesale clients if they satisfy certain tests: product value, professional investors; small businesses; and individual wealth.

The tests

- **The product test:** the value of the financial product or financial service is greater than \$500,000.
- **Professional investor test:** this includes Australian Financial Services Licensees, Australian Prudential Regulation Authority regulated bodies, trustees of public superannuation funds, persons controlling at least \$10 million and the trustee of a superannuation fund which has net assets of at least \$10 million.
- **Small business test:** the consumer of the financial products or services is a business which is not a small business (that is, a non-manufacturing business with more than 20 employees or a manufacturing business with more than 100 employees).

- **Individual wealth test:** The monetary thresholds are set at \$2.5 million in net assets, or gross income for each of the last two financial years of at least \$250,000 per annum. The rationale behind these monetary thresholds is that investors meeting one of these criteria would be more capable of evaluating the financial products being offered without needing the protections of a regulated disclosure document such as a prospectus or product disclosure statement. ASIC notes that “Generally, people buying securities and other financial products must, under the Corporations Act 2001, be given a regulated disclosure document such as a prospectus or product disclosure statement. However, one of the exemptions in the Act is the offering of financial products to a person (either a natural person or a legal person) who is the subject of a current certificate from a qualified accountant certifying they have a prescribed net asset or gross income level.” The certificate is valid for two years.

Insurance, superannuation, retirement savings account products and traditional trustee company services are treated differently. Where a financial service relates to a superannuation product, a trustee of a self-managed superannuation fund will be classified as a retail client unless the fund holds net assets of at least \$10 million at the time the service is provided.

The individual wealth test is the one most popularly used to categorise clients as wholesale. Clients categorised as wholesale clients under this test are also referred to as high net worth clients or (confusingly) sophisticated investors.

Sophisticated investor test

In 2007, a definition of ‘sophisticated investor’ was introduced to Chapter 7 of the Corporations Act. This new section mirrored section 708 (10) and aimed to apply the same tests that applied to securities and debentures in Chapter 6D of the Corporations Act, thus providing a more consistent regulatory approach to disclosure across a larger range of financial products. The class of sophisticated investors was intended to be



a subset of wholesale clients. Although the existing tests had adequately addressed the circumstances of many investors, Parliament considered that there were some investors defined as retail who were unable to access wholesale status and that for reasons such as experience or professional training, these investors may wish to be treated as wholesale investors to access wholesale investor status and wholesale-only products. Sophisticated investors also are exempt from having to be provided with a regulated disclosure document.

Licensees have obligations to certify in writing their reasons for being satisfied that a sophisticated client has previous experience in investing in securities and other financial products. The certification is to show that the client can assess the merits, value; and associated risks of the product and both their own information needs and the adequacy of the information provided by the licensee.

Sophisticated investors are also referred to as experienced investors.

Confusion

In much commentary, the terms 'high net worth' and 'sophisticated investor' are used interchangeably, even though they are referring to different investor categories.

Confusingly:

- section 708 (8) of the Corporations Act (Chapter 6) defines high net worth investors (those who satisfy the product test or the net assets and/or gross income tests) as 'sophisticated investors' in its heading
- section 761GA of the Corporations Act (Chapter 7) defines 'sophisticated investors' as those who satisfy the experience test.

As noted, 'wholesale clients' refer to all clients who are not considered to be retail clients. In this paper 'high net worth investor' is a reference to those who satisfy the net assets and/or gross income tests in sections 708 (8) and 761G (7) and 'sophisticated investor' is a reference to those investors who satisfy the experience test in sections 708 (10) and 761GA.

2011 review of the individual wealth test

Treasury undertook a consultation in January 2011 as part of the Future of Financial Advice reforms on various options for the criteria under which a client was considered to be wholesale or retail in the context of receipt of financial advice.¹⁴ There was concern that during the global financial crisis many investors suffered losses, because monetary thresholds do not accurately measure the financial literacy of investors and can fail to protect wealthy investors with limited investment experience.

Options presented in the consultation paper included:

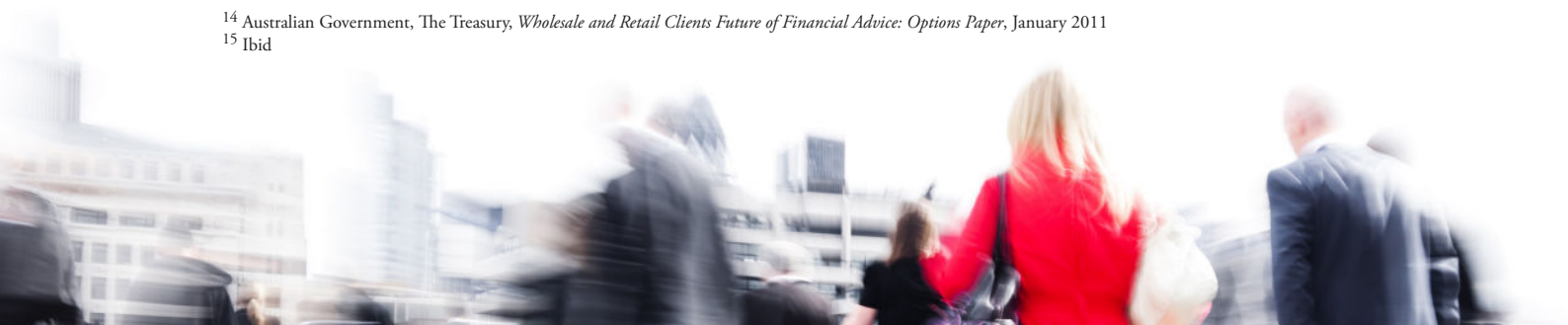
- indexing the wealth tests so that they remain relevant over time
- excluding the client's primary residence (family home) and superannuation from the net wealth threshold
- changing the process by which clients are deemed to be wholesale to require specific acknowledgement from the client that they will be classed as a wholesale client and they will not receive the benefit of protections provided to retail clients
- repealing the 'sophisticated investor' test on the basis that it is scarcely used and is subjective
- removing the distinction between wholesale and retail clients, thus ensuring high levels of investor protection
- eliminating the wealth thresholds and introducing a 'sophisticated investor' test as the sole way to distinguish between wholesale and retail clients.

The consultation paper noted that "Arguably the approach to defining 'sophisticated investors' is a more appropriate way to distinguish whether they are able to deal with complex financial products than a simple wealth test. Although, the subjective nature of the 'sophisticated investor' test places the onus on the licensee, creates less certainty and makes it difficult to determine if a [accountant's] certificate was properly issued."¹⁵

There was no consensus in the 30 submissions Treasury received in response to the consultation. Some responses noted that the distinction between retail and wholesale clients permeated the whole fabric of financial services

¹⁴ Australian Government, The Treasury, *Wholesale and Retail Clients Future of Financial Advice: Options Paper*, January 2011

¹⁵ Ibid



regulation and consequently the way the financial services industry is structured and there was no evidence to suggest that further increases in the monetary thresholds would continue to correlate with financial literacy and experience. Others called for an increase in and indexing of the monetary thresholds and the exclusion of the family home from the assets test.

In its response to the consultation, SIAA queried the lack of a clear rationale behind the proposals and raised concerns about the possible detrimental effects of the proposals on capital raising, particularly in the small and mid-cap sectors.

The government took no action in response to the consultation and the individual wealth test remained unchanged.

International comparisons

Australia is not an outlier when it comes to the threshold for wholesale investors. Almost all major jurisdictions set their monetary wholesale investor thresholds at a lower level, although some exclude assets like the family home from the calculation.

United States of America

The United States of America has definitions similar to the Australian definition of wholesale investors. The wealth threshold for a natural person is set at an individual net worth or joint net worth with that person's spouse exceeding US\$1 million. The value of a natural person's family home is excluded from the calculation. The income test is income exceeding US\$200,00 in each of the two most recent years or joint income with a spouse exceeding US\$300,000 for those years and a reasonable expectation of the same income level in the current year.

United Kingdom

In the UK, investors can self-certify as a High Net Worth investor or a Sophisticated Investor. The "High Net Worth" investor test is net assets (excluding any primary residence, pensions and contract of insurance) of £250,000 or more, or an income threshold of £100,000 per annum.

A Sophisticated Investor is one that self-certifies as satisfying one of the following conditions:

- been a director of a company turning over at least £1 million within the last two years
- made more than one investment in an unlisted company in the last two years
- been a member of a network or syndicate of business angels for at least six months
- worked in the past two years in a professional capacity in the private equity sector or in the provision of finance for small and medium enterprises.

Hong Kong

Hong Kong has a single asset test of securities, cash and/or cash equivalents portfolio of roughly \$US1 million.

Singapore

Singapore has the "Accredited Investor" classification for individuals with a net assets test of an amount exceeding SG\$2 million (of which the net value of the investor's primary place of residence can only contribute up to SG\$1 million) or an annual income test of not less than SG\$300,000.

New Zealand

New Zealand has a net assets test of NZ \$5 million. It has no investor income threshold test.

Investors can self-certify to be an 'eligible investor' in relation to a particular transaction if they have sufficient experience in acquiring or disposing of financial products to be able to assess:

- the merits of the transaction
- their own information needs in relation to the transaction, and
- the adequacy of the information provided by any person involved in the transaction.

That certification requires a financial adviser, a qualified statutory accountant, or a lawyer to sign the certification stating they are satisfied the investor has been sufficiently advised of the consequences of self-certification and have no other reason to consider the self-certification is incorrect or that further information or investigation is required. ■





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