



ASIC

Australian Securities & Investments Commission

CONSULTATION PAPER 119

Regulation of financial markets: Exemptions from Part 7.2 of the Corporations Act

February 2006

What this paper is about

1 This consultation paper sets out a proposal to extend the circumstances in which ASIC may consider recommending to the Minister that an exemption from Part 7.2 of the *Corporations Act 2001* (Act) should be granted. We consider that this proposal will facilitate the more appropriate regulation in this jurisdiction of some specialist market facilities that function to bring professional investors together to trade in financial products solely among themselves.

2 This paper explains:

- (a) the way in which financial markets are regulated under Part 7.2 of the Act and our experiences in applying the Australian market licence regime;
- (b) the proposal that on a case-by-case basis, we will generally recommend to the Minister that he or she grant an exemption from Part 7.2 of the Act for a particular facility that provides limited market services to users who are all professional investors (acting on their own behalf or on behalf of other professional investors);
- (c) the conditions that we generally expect to recommend that the Minister imposes on that exemption; and
- (d) other issues that we regard this proposal as giving rise to.

Note: For copies of ASIC publications mentioned in this paper, such as class orders (CO), information releases (IR) and frequently asked questions (QFS), go to www.asic.gov.au or contact ASIC Infoline on 1300 300 630.

Your feedback is invited

3 We invite you to comment on our proposal and the issues for consideration in this paper. Please include any qualitative or quantitative information to support your comments or arguments. All submissions will be treated as public documents unless you specifically request that we treat the whole or part of your submission as confidential. We are planning to issue a revised version of Policy Statement 172 *Australian market licences: Australian operators* [PS 172], which reflects our experiences with Part 7.2 of the Act. The proposal in this paper may be ultimately reflected in any revision we make to that policy statement.

Your comments

Comments are due by **28 February 2006** and should be sent to:

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Section 1: Our experiences in applying Part 7.2

1.1 Under s791A of the Act, a person must only operate, or hold out that the person operates, a financial market in this jurisdiction if:

- (a) the person has an Australian market licence that authorises the person to operate the market in this jurisdiction; or
- (b) the market is exempt from the operation of Part 7.2 of the Act.

1.2 The term ‘financial market’ is broadly defined under s767A of the Act and covers a range of facilities on which offers to acquire or dispose of financial products are regularly made or accepted. The definition covers a broad range of facilities, from simple bulletin boards on which participants can make but not accept bids and offers to widely used markets with extensive and sophisticated infrastructure.

1.3 In Policy Statement 172 *Australian market licences: Australian operators* [PS 172], we state that the purposes of market regulation are to:

- (a) protect market users; and
- (b) enhance market integrity and financial system stability.

1.4 Market regulation achieves these purposes primarily by requiring market operators to be licensed and to comply with the licensee obligations.

1.5 In [PS 172] we have indicated that when applying the Australian market licence regime we will do so flexibly, considering the features of the facility in question. However, our ability to tailor the Australian financial market licence regime is limited. Except for certain provisions in the case of self-listed licensees, Part 7.2 does not give ASIC or the Minister the power to modify or grant exemptions from the obligations of an Australian market licensee.

1.6 Our experience in administering the markets regime introduced by the Financial Services Reform Act suggests that the Australian market licence regime may be unduly burdensome for some limited, specialist facilities whose function is to bring professional investors together to trade in financial products solely among themselves. Not all the public policy outcomes the markets licensing regime is intended to produce are relevant to these kinds of facilities. The public policy outcomes that are relevant can arguably be achieved more efficiently by adapting the Australian financial services (AFS) licence regime rather than applying the full market licence regime, without lessening market integrity or system stability goals.

1.7 We have in mind to use this approach to specialised facilities that assist professional investors to initiate transactions and trade with each other in a range of financial products that are not usually traded on facilities

used by retail clients. Traditionally, the types of transactions effected on facilities of this kind are likely to have been undertaken over the telephone. However, as technology evolves, these trading arrangements may now take place electronically through facilities available to these sophisticated entities to take place using an electronic format. Similar to the way in which settlement traditionally occurred for transactions of this type, settlement of trades conducted on these facilities takes place between counterparties and outside the relevant system.

1.8 Our experience has been that because of the sophisticated nature of the users of these types of markets and the way in which some of these financial markets are regulated in other jurisdictions, operators of these types of facilities do not typically anticipate being obliged to monitor the conduct of all participants and to supervise the market in the manner contemplated by the Act for licensed financial markets. Nor have we had any real sense that users of these types of markets anticipate them doing so. Our experience also suggests these types of market facilities do not have operating rules intended to perform the functions or meet the content requirements contemplated by the Act. For these and other reasons a number of operators of these types of facilities argue that the costs of complying with the Australian market licence regime are out of line with costs internationally, and do not result in corresponding market integrity or system stability outcomes. They also suggest that many of the regulatory outcomes of the Australian market licence regime are not relevant or can be achieved through more cost effective means for these types of facilities.

1.9 A number of major jurisdictions approach the regulation of these types of market facilities in different ways. In this context, regulators in these overseas jurisdictions do not seek to regulate the facilities to which this paper relates as financial markets in the same manner in which traditional exchange type markets are regulated. To this extent, the ‘one-size-fits-all’ regime contemplated by an Australian market licence appears inconsistent with the approach taken in these other jurisdictions.

1.10 For these reasons we think that there is benefit in broadening the circumstances in which we may consider recommending an exemption from Part 7.2 of the Act so as to include the types of facilities discussed in this paper. We believe that there may be other regulatory tools to achieve the purposes of market regulation and maintain confidence in the integrity of Australian financial markets as a whole while allowing these types of financial markets to operate to the benefit of market users.

Section 2: Our proposal

2.1 We are inclined to broaden the circumstances in which we may consider recommending to the Minister that an exemption from Part 7.2 of the Act should be granted. Specifically, we are inclined to recommend to the Minister that an exemption from Part 7.2 of the Act should generally be granted for a financial market facility that has the following characteristics:

- (a) all market users are professional investors who participate in that market on their own behalf or on behalf of other professional investors;
- (b) trading is not anonymous (i.e. prior to transactions being entered into a market user can identify its counterparty or its counterparty can only be one of a limited number of markets users which are known to that market user);
- (c) a limited range of specialised financial products are traded on the facility which are not usually traded on public markets used by retail clients; and
- (d) contracts are formed between market users directly without the involvement of a central counterparty.

2.2 We propose to consider and make each recommendation to the Minister on a case-by-case basis.

2.3 In circumstances in which we recommend to the Minister that a financial market of this nature should be exempt from Part 7.2 of the Act, we generally anticipate that we will recommend to the Minister that the type of conditions set out in Section 3 should be imposed on that exemption.

2.4 It is important to emphasise that our proposal only relates to trading facilities used exclusively by professional investors. Our proposal will not affect the approach that we have stated we will take in relation to recommending exemptions for other types of financial markets: see [PS 172].

Why introduce this proposal?

2.5 We are making this proposal because our experience has been that this may be a more appropriate means of regulating financial markets with the features described in paragraph 2.1. Our experience has also been that this approach is more consistent with the approach taken by various other regulators, which regulate traditional exchanges differently from those with other features.

Case-by-case exemption

2.6 We are inclined to recommend to the Minister that an exemption from Part 7.2 of the Act should be granted for the type of market facilities described in paragraph 2.1. But we propose to consider each application and make our recommendation to the Minister on a case-by-case basis. We do not propose to recommend the creation of (for example) a class exemption for the types financial markets with those features.

2.7 We propose to follow this approach to ensure that each application is considered on its merits and to ensure that any advice we provide about an application, and any conditions we recommend, can be tailored to deal with specific issues relevant to the market facility in question. We consider that there will be a number of factors pertaining to the operation of the type of facility described in paragraph 2.1 which will assist us in coming to the conclusion that it should be exempt from Part 7.2 of the Act. The following is a non-exhaustive list of matters that are likely to be relevant to our consideration of whether we should recommend to the Minister that an exemption is appropriate:

- (a) the number of market users;
- (b) the likely size and volume of trading on the facility;
- (c) the nature and number of the financial products traded on the facility;
- (d) what arrangements are adopted to result in reliable contract formation between market users, and the nature of the contractual framework between market users and the operator;
- (e) the extent to which Australian market users will use the facility (as opposed to non-Australian market users);
- (f) what arrangements there are for ensuring that market users do not participate in the market on behalf of retail investors;
- (g) what arrangements there are for the operator to monitor compliance by market users with user agreements and trading obligations, and the action the operator will take for non-compliance;
- (h) if relevant, how the facility is regulated outside this jurisdiction;
- (i) whether users of the facility would expect the facility to be regulated under the Australian market licence regime;
- (j) the extent to which the integrity and stability of the market depends on:
 - (i) comprehensive supervision by the market operator; and
 - (ii) rules under which the facility operates being subject to ongoing regulatory supervision by the Minister;

- (k) the impact on the fair, orderly and transparent operation of other financial markets operated in Australia; and
- (l) the likely impact of the failure of the market on the reputation of the Australian financial system generally.

2.8 We do not anticipate recommending an exemption from Part 7.2 of the Act under this proposal for a facility that will operate in a similar manner to a licensed market usable by retail clients, but which in practice is simply limited to professional investors or other financial products that are ordinarily traded by retail clients.

2.9 We also do not anticipate recommending an exemption in relation to a facility on which shares in a body, or interests in a managed investment scheme, are traded.

Your feedback: Section 2

- Q2.1** Do you agree that we should generally recommend an exemption from Part 7.2 of the Act for financial markets with the features in paragraph 2.1? Please give reasons in support of your view.
- Q2.2** Do you agree that we should consider each application on a case-by-case basis (as opposed to, for example, recommending the creation of a class order exemption)?
- Q2.3** Do you agree with the list of matters that may be relevant to our consideration of whether to make a recommendation to the Minister listed at paragraph 2.7? If you believe that any of the matters listed are not relevant or that other matters should be considered please give reasons to support your view.
- Q2.4** If you consider that a class order exemption is the appropriate way in which the relevant facilities should be regulated, how would you define the characteristics of the class of facilities that should have the benefit of a class exemption?
- Q2.5** Do you think ASIC should take into account the purposes for which financial products traded on a facility are acquired by participants in those facilities as a relevant consideration in deciding whether ASIC should recommend to the Minister that an exemption is appropriate? Please give reasons in support of your view.

Section 3: Conditions of exemption

3.1 In circumstances in which we recommend to the Minister that an exemption from Part 7.2 of the Act is appropriate for a particular market facility with the features described in paragraph 2.1, we anticipate generally also recommending to the Minister that the exemption should be granted on the conditions set out in this section. If we consider that the nature of the relevant market facility requires us to do so, then we will also recommend that other conditions should be imposed on the exemption.

3.2 An alternative approach may be for these conditions to be imposed by way of conditions to an AFS licence.

Australian financial services (AFS) licence

3.3 We propose to recommend that the operator of the exempt financial market facility is required to hold an AFS licence that covers the financial services associated with the operation of the market facility. As the operator of a financial market, the applicant at very least may be engaging in the financial service of ‘arranging’ and/or ‘dealing’ in the financial products that are traded on that market facility: see QFS 125 *What is our approach to ‘arranging’?*

3.4 We expect to recommend that the operator must hold an AFS licence as a condition of the exemption from Part 7.2 of the Act even if the applicant may otherwise be exempt from the requirement to hold an AFS licence. There are a range of circumstances in which an applicant may be exempt from the requirement to hold an AFS licence and Policy Statement 176 *Licensing: Discretionary powers—wholesale foreign financial service providers* [PS 176] discusses circumstances that may be particularly pertinent to certain foreign operators. Despite this, we propose to recommend that the operator is required to hold an AFS licence as a condition of the exemption from Part 7.2 of the Act because we do not consider it appropriate for ASIC not to have direct regulatory powers over an entity that would otherwise be required to obtain and meet the obligations of an Australian market licence. We consider that the requirement to hold an AFS licence will achieve an appropriate regulatory balance, when coupled with the other conditions of the market exemption we are contemplating in this proposal.

Periodic reporting requirements

3.5 We also propose to recommend that the Minister imposes various periodic reporting requirements as conditions on an exemption from Part 7.2 of the Act.

3.6 Specifically, we propose to recommend that within 30 days following each six-month period ending 30 June and 31 December

during which the market is operated in this jurisdiction, the operator must give ASIC the following information:

- (a) for each contract that can be traded on the relevant facility, the total trade volume that was conducted by Australian participants for that six-month period;
- (b) the proportion of worldwide trading volume on the market that was conducted by Australian participants for that six-month period; and
- (c) the current name and business address in Australia for each Australian participant in the market during that six-month period.

3.7 These conditions are similar to those that appear on various Australian market licences and exemptions in relation to financial markets currently operating in this jurisdiction. The purpose of these reporting conditions is to provide us with an ongoing understanding of the nature and extent of activity conducted on the relevant market facility.

3.8 As a further periodic reporting obligation, we also propose to recommend that the operator must, as soon as practicable, advise us in writing if:

- (a) they take any disciplinary action against a user of the market:
 - (i) the user's name; and
 - (ii) the reason for and nature of the action taken; and
- (b) the operator has reason to suspect that a person has committed, is committing or is about to commit a significant contravention, of the Act or rules relating to trading on the market:
 - (i) the person's name; and
 - (ii) details of the contravention or impending contravention; and
 - (iii) the operator's reason for that belief.

3.9 These obligations are adapted from those that would otherwise be imposed on Australian market licensees under s792B(2) of the Act and are intended to provide us with information that we consider is relevant in determining the ongoing integrity of the facility.

3.10 In the context of an exemption that we are contemplating under this proposal, disciplinary action may involve the facility operator pursuing remedies for breach of contract or the exercise of other legal rights that the operator of the facility may have in circumstances where the market user breaches their obligations to the operator or other market users.

Annual reporting requirements

3.11 We propose to also recommend to the Minister that in addition to the conditions relating to periodic reporting, that operators are also required to prepare an annual report that must be submitted to us within three months of the end of the relevant operator's financial year. We propose to recommend that in this report the operator must set out the extent to which it has complied with the conditions of the relevant exemption and that the report must also be accompanied by:

- (a) a description of the activities that the operator has undertaken in the financial year;
- (b) the number, duration, cause and resolution of material system outages that prevented Australian participants from using the market facility;
- (c) the name and number of Australian participants authorised to access the market facility at the beginning and end of the financial year respectively;
- (d) details for the financial year concerning the volume of trading on the market facility;
- (e) the number and nature of complaints made to the operator by users of the market facility and the action taken by the operator in response to each complaint identified;
- (f) any specific regulatory issues that the operator encountered during the year (including for foreign operators, any change in regulatory status in their home jurisdiction) and actions taken to resolve these issues (whether inside or outside this jurisdiction); and
- (g) details of any significant conflicts of interest identified by the operator in relation to its operation of the market facility and how these were resolved.

3.12 We also propose to recommend that the Minister imposes a condition whereby he or she may, by giving written notice to the operator, require the operator to obtain an audit report on this annual report and on any information or statements accompanying it. We propose that, the Minister may nominate:

- (a) ASIC; or
- (b) a specified person or body that is suitably qualified,

to prepare the audit report and that ASIC must give the annual report and accompanying material to the Minister.

3.13 The conditions proposed in paragraphs 3.11 and 3.12 are adapted from the obligations that would otherwise be imposed on Australian market licensees by s792F of the Act and are intended to provide us with

an understanding of the nature and extent of the activity that has been conducted on the market facility during the year to which the report relates. The information sought in paragraph 3.11 (a)–(g) is either specified in the Act or is information we typically advise Australian market licensees that we require as part of the information provided under s792F of the Act.

Clearing and settlement arrangements

3.14 We also propose to recommend that the Minister imposes a condition that the operator (or its associated entity):

- (a) must not operate a clearing and settlement facility for the market; and
- (b) may provide clearing and settlement arrangements for the market only by providing information and by establishing procedures for the settlement of transactions effected through the market.

3.15 The purpose of recommending this condition is to limit the nature of the activities that operators of the types of financial markets described in paragraph 2.1 may otherwise engage in. Our experience has been that transactions effected through these types of market facilities are settled between market users and outside of the market system. If the operator (or its associated entity) is also operating a clearing and settlement facility for transactions effected through the market, then we may consider this to be an indication that the facility involves a more extensive range of activities than would be appropriate for an exemption from Part 7.2 of the Act. The Minister has already taken this approach in the *Corporations (Foreign Exchange Markets) Exemption Notice 2004* (as amended), which contains a condition preventing the operation of a clearing and settlement facility for the types of facilities covered by that exemption.

Co-operation arrangements

3.16 We propose to also recommend that the Minister imposes a condition that the operator must enter written co-operation arrangements with us. We currently require all Australian market licensees to enter into written arrangements to facilitate their co-operation and information sharing. A number of the issues in our ‘standard’ current co-operation arrangements address consequences of the operator being regulated under Part 7.2 of the Act and are intended to ensure that those relevant obligations are met in a timely and appropriate manner. While many of those issues will not arise if the market facility in question is exempt from Part 7.2 of the Act, we still consider that some value can be obtained by having the operator undertake in writing to meet the co-operation and information sharing obligations that still remain as conditions of the proposed exemption.

Operate as set out in the application

3.17 Finally, we propose to recommend that the Minister imposes a condition that the market must be operated in materially the same way as its operation is described in the exemption application. This condition currently appears in the notice of exemption for a number of financial markets operated in this jurisdiction and is intended to ensure that the way in which the market facility is operated is not altered to the extent to which an exemption from Part 7.2 of the Act may no longer be appropriate.

Your feedback: Section 3

- Q3.1** Is there any reason why an operator should not be required to hold an AFS licence as a condition of the exemption from Part 7.2 of the Act?
- Q3.2** Is there any reason why an operator should not be required to meet the periodic reporting requirements as a condition of the exemption from Part 7.2 of the Act?
- Q3.3** Is there any reason why an operator should not be required to meet the annual reporting requirements as a condition of the exemption from Part 7.2 of the Act?
- Q3.4** Is there any reason why an operator (or its associated entity) should not be prohibited from operating a clearing and settlement facility as a condition of the exemption from Part 7.2 of the Act?
- Q3.5** Is there any reason why an operator should not be required to enter into written co-operation arrangements with us as a condition of the exemption from Part 7.2 of the Act?
- Q3.6** Is there any reason why, as a condition of the exemption from Part 7.2 of the Act, an operator should not be required to operate the financial market in materially the same way as its operation is described in the exemption application?
- Q3.7** Are there any other conditions that you think should be imposed on the operators of financial markets that may have an exemption from Part 7.2 as contemplated by this proposal?
- Q3.8** Should the proposed conditions be imposed by way of conditions on an AFS licence or as conditions to an exemption granted by the Minister? Please give reasons which support your view.

Section 4: Other considerations

4.1 The Act imposes a number of obligations on financial services licensees that seek to protect consumers in circumstances in which financial products are *able to be traded* on a 'licensed market'. A licensed market is a financial market, the operation of which is authorised by an Australian market licence. If the Minister grants an exemption from Part 7.2 of the Act in relation to a particular financial market, then that market will not be a 'licensed market' and the requirement to comply with those obligations will not technically arise.

4.2 We have considered the circumstances in the Act which give rise to this issue. For the most part, we consider that those circumstances are not relevant to the types of markets described in paragraph 2.1. However, one circumstance which may be relevant is set out in s991B (and reg 7.8.17). That section requires holders of AFS licences to give priority to client orders if they are instructed to buy or sell financial products that are able to be traded on a licensed market of which the financial services licensee is a participant. If a particular market is exempt from Part 7.2 of the Act, then that obligation in relation to that market will not apply.

4.3 We consider that adherence to the principle in s991B of the Act is important in the appropriate functioning of any market facility. For that reason, we seek comment on how best to address this issue.

4.4 One approach may be to recommend that the Minister imposes a condition on the exemption that requires operators to ensure that AFS licence holders who use the market give priority to client orders in the manner contemplated by s991B of the Act. However, it may be difficult to effectively impose the obligation in s991B as the provision is directed at market users (not market operators). Another approach may be to include an obligation under the periodic reporting conditions (in paragraph 3.8) that the operator must, as soon as practicable, advise us in writing if they have reason to suspect that a person has failed, is failing, or is about to fail to give priority to client orders as contemplated by s991B. Alternatively, it is our experience that a significant number of the types of markets described in paragraph 2.1 have market users that do not act on behalf clients and it may be that we should not be concerned about this issue.

Your feedback: Section 4

- Q4.1** Do you consider that it is appropriate to recommend a condition on an exemption from Part 7.2 of the Act that requires operators to ensure that AFS licence holders give priority to client orders as contemplated by s991B?
- Q4.2** Do you consider it appropriate to recommend a condition requiring a further obligation in addition to those already proposed under the requirements for periodic reporting?
- Q4.3** Alternatively, is this an issue that we should not be concerned about and if so, why?
- Q4.4** Are there any other comments you have on the application of s991B to the facilities that we are proposing may have an exemption from Part 7.2 of the Act?

Key terms

In this consultation paper, terms have the following meanings.

Act The *Corporations Act 2001*, including regulations made for the purposes of that Act.

AFS licence An Australian financial services licence under s913B that authorises a person who carries on a financial services business to provide financial services.

Australian market licence A licence under s795B of the Act that authorises a person to operate a financial market.

associated entity An associated entity under s9 of the Act.

ASIC The Australian Securities and Investments Commission.

clearing and settlement arrangements Arrangements for the clearing and settlement of transactions effected through a financial market, as defined in s790A of the Act.

clearing and settlement facility A facility that provides a regular mechanism for parties to transactions relating financial products to meet obligations to each other that:

- (a) arise from entering into the transactions; and
- (b) are of a kind prescribed by regulation,

as defined by s768A of the Act.

financial product A product as defined in Division 3 of Part 7.1 of the Act.

financial market A facility through which:

- (a) offers to acquire or dispose of financial products are regularly made or accepted; or
- (b) offers or invitations are regularly made to acquire or dispose of financial products that are intended to result or may reasonably be expected to result, directly or indirectly, in:
 - (i) the making of offers to acquire or dispose of financial products; or
 - (ii) the acceptance of such offers.

as defined in s767A of the Act.

financial services licensee A person who holds an AFS licence.

managed investment scheme As defined in s9 of the Act.

operating rules As defined in s761A of the Act.

participant As defined in s761A of the Act.

professional investor A person in relation to whom one or more of the following paragraphs apply:

- (a) the person is a financial services licensee;
- (b) the person is a body regulated by APRA, other than a trustee of any of the following (within the meaning of the *Superannuation Industry (Supervision) Act 1993*):
 - (i) a superannuation fund;
 - (ii) an approved deposit fund;
 - (iii) a pooled superannuation trust;
 - (iv) a public sector superannuation scheme;
- (c) the person is a body registered under the *Financial Corporations Act 1974*;
- (d) the person is the trustee of:
 - (i) a superannuation fund; or
 - (ii) an approved deposit fund; or
 - (iii) a pooled superannuation trust; or
 - (iv) a public sector superannuation scheme;
 within the meaning of the *Superannuation Industry (Supervision) Act 1993* and the fund, trust or scheme has net assets of at least \$10 million;
- (e) the person has or controls gross assets of at least \$10 million (including any assets held by an associate or under a trust that the person manages);
- (f) the person is a listed entity, or a related body corporate of a listed entity;
- (g) the person is an exempt public authority;
- (h) the person is a body corporate, or an unincorporated body, that:
 - (i) carries on a business of investment in financial products, interests in land or other investments; and
 - (ii) for those purposes, invests funds received (directly or indirectly) following an offer or invitation to the public, within the meaning of s82 of the Act, the terms of which provided for the funds subscribed to be invested for those purposes;
- (i) the person is a foreign entity that, if established or incorporated in Australia, would be covered by one of the preceding paragraphs.

QFS 125 (for example) A ‘frequently asked question’ posted on ASIC’s website at www.asic.gov.au (in this example numbered 125).

reg 7.8.17 (for example) A regulation from the *Corporations Regulations 2001* (in this example numbered 7.8.17).

retail client A person identified as a retail client in s761G of the Act.