ASIC
Australian Securities & Investments Commission

ASIC MINISTERIAL SUBMISSION TO
THE HON STEPHEN JONES MP, ASSISTANT TREASURER & MINISTER FOR FINANCIAL SERVICES

17 August 2022 ASIC ID: 2022/018

RETAIL CLIENT, WHOLESALE CLIENT AND SOPHISTICATED INVESTOR DEFINITIONS

PURPOSE - For information only

The purpose of this submission is to provide the Assistant Treasurer & Minister for Financial Services an update on ASIC's views in respect of the 'retail client', 'wholesale client' and 'sophisticated investor' definitions in the *Corporations Act 2001* (Corporations Act).

KEY POINTS

- In ASIC's view, the retail client, wholesale client and sophisticated investor definitions in Chapter 6D and Chapter 7 of the Corporations Act are complex and outdated. While ASIC has not undertaken a thorough review of the reform options in recent years, at a minimum, we consider the net assets, gross income and product value tests should be updated and indexed to extend the retail client protections to a broader class of consumers. This could be done in isolation, or as an initial step ahead of any broader review of potential changes to the policy settings, including with reference to any recommendations from the Australian Law Reform Commission and Quality of Advice Reviews.
- Academic research and commentary also criticise the asset and income tests as outdated and no longer fit for purpose:
  - Some commentary has noted that rising house prices in the Australian market have driven up the eligibility to be classed as a wholesale client from 1.9% to 16% of the adult population, thus enabling inexperienced investors to fall into the category of wholesale clients based on property ownership.
  - Recent research by ANU Associate Professor Ben Phillips also projects that, by 2031, 29.1% of individuals could classify as wholesale/sophisticated and 43.6% of individuals by 2041.
- ASIC notes that, as a matter of practice, provisions containing fixed value thresholds can be periodically indexed and/or updated. A risk with moving such thresholds to a more complex system (e.g., regular automatic indexation) is that it can create transitional uncertainty at the time of each change. Despite this uncertainty, updating the thresholds will go some way to improving the alignment of the tests with their policy intent. For example, had the net assets test been indexed by CPI from 2001, this amount would now be over $4 million, rather than the current $2.5 million.
- ASIC is concerned about situations where vulnerable investors have been misclassified as wholesale clients and lost money. These investors may not objectively have the required level of experience or understanding of the risks associated with complex products and the consequences of the wholesale client classification – i.e., that they would not be afforded important consumer protections. One example of where this issue arose is in ASIC's action against Mayfair 101 group in 2020 and 2021.
- We also note that the Australian Law Reform Commission (ALRC) is currently considering the definitions as part of its *Review of the Legislative Framework for Corporations and Financial Services Regulation* (the ALRC Review). In addition, the Quality of Advice Review has sought submissions on client understanding and consent to being classified as a wholesale client.

Karen Chester
Deputy Chair
M: s 22 [redacted]

Danielle Press
Commissioner
M: s 22 [redacted]

Joanna Bird
Executive Director, Financial Services Wealth
M: s 22 [redacted]

Greg Kirk
Executive Director, Strategy Group
M: s 22 [redacted]

ADDITIONAL INFORMATION

Retail and wholesale clients

- Introduced following the Financial System Inquiry (Wallis Inquiry) in 2001, the policy rationale for the distinction between retail and wholesale clients was to identify those in need of regulatory protection and to allow certain clients to participate in wholesale markets, which tend to trade in more complex products. The rationale was that wholesale clients (as measured by their assets and income) are better informed and can better assess risk in financial products, and therefore do not require the same level of protection as retail clients under the framework.
- Sophisticated investors and other wholesale clients can participate in a range of product offers and capital raisings that may not be available to retail investors (e.g., wholesale-only funds, structured products, equity placements and private equity raisings).
- Under Chapter 7 of the Corporations Act, a client is presumed to be a 'retail client' unless they satisfy other criteria (refer s 761G(1)). There are various tests in ss 761G and 761GA under which a client may be classified as wholesale, including:
  - *net assets or gross income test* – if a qualified accountant certifies that the client has net assets of at least $2.5 million or gross income of $250,000 for each of the last two financial years;
  - *price or value test* – if the price or value of financial products or services that the client is acquiring is at least $500,000 (this test does not apply to contracts for difference (CFDs));
  - *sophisticated investor test* – see below.
- The tests and definitions are supplemented by complex and extensive regulations in Part 7.1, Division 2 of the Corporations *Regulations 2001*. In *Australian Securities and Investments Commission v Westpac Banking Corporation* [2019] FCA 2147 [12], Wigney J referred to the definition of 'retail client' as 'rather tortuous'. The net assets or gross income and the price or value tests have not been updated since 2001, except for changes relating to specific products such as CFDs, and margin lending facilities.
- In 2019, the Corporations Regulations were amended at ASIC's request so that the 'price and value' wholesale client test no longer applied to CFDs. This change prevented the avoidance of ASIC's product intervention order (e.g., at 500:1 leverage, a CFD with a notional value of $500,000 could be opened using only $1,000 initial margin).
- Retail clients are afforded certain protections under the Corporations Act. In recent years a greater suite of protections apply to retail clients, giving the classification more significance. These include:
  - compensation obligations under Part 7.5;
  - disclosure obligations under Parts 7.7 and 7.9;
  - conduct obligations, such as the 'best interests' obligations that apply to the provision of financial product advice under Part 7.7A;
  - the design and distribution obligations in Part 7.8A;
  - the external dispute resolution obligations under Part 7.10A; and
  - product intervention orders made by ASIC under Part 7.9A (for example, orders restricting the issue and distribution of CFDs and binary options to retail clients).

Indexation

- Provisions containing fixed thresholds, such as the definition of a wholesale client in the asset and income exceptions in s 761G(7)(c) of the Corporations Act, can be periodically indexed.
- For example, the prescribed amount in relation to 'acquiring financial services as a consumer' in the ASIC Act/Australian Consumer Law was set at $40,000 in 1986, and updated to $100,000 in 2020, to reflect inflation during the intervening period (see Australian Consumer Law review proposal 15).
- There has been some support from industry for increasing the dollar amounts of the wealth thresholds. For example the FSC publicly supports doubling the minimum asset threshold from $2.5m to $5m from 2023 and indexing against household inflation.
- In their submissions to the ALRC's Interim Report A at para 113, consumer groups noted that the general assumption that a certain level of wealth was an accurate measure of sophistication may not be appropriate, and recommended aligning the definition of 'retail client' with the definition of 'consumer' in

the ASIC Act to apply where 'services are of a kind ordinarily acquired for personal, domestic or household consumption'.

Sophisticated investors

- In 2007, the term 'sophisticated investor' was introduced to Chapter 7 of the Corporations Act (s 761GA). The section mirrors s 708(10) and aims to apply the same tests that apply to securities and debentures in Chapter 6D. A 'sophisticated investor' is a type of wholesale client assessed by a subjective test.
- A 'sophisticated investor' is described in the Act as a retail client for whom 'the licensee is satisfied on reasonable grounds that the [client] has previous experience in using financial services and investing in financial products that allow the client to assess:
  - the merits of the product or service; and
  - the value of the product or service; and
  - the risks associated with holding the product; and
  - the client's own information needs; and
  - the adequacy of the information given by the licensee and the product issuer…'.
- To consider the client as a sophisticated investor, the licensee must also give the client written reasons for being satisfied as to those matters and the client must sign a written acknowledgement that, among other things, the licensee does not have obligations under Chapter 7 that they would otherwise have if the client was a retail investor.
- Treasury in a 2011 Options paper indicated that there is hesitation on the part of AFS licensees to apply the 'sophisticated investor' exception due to its complexity and liability for incorrect classification. We found that the sophisticated investor test was used for 82.5% of consumers classified as wholesale clients by the 12 largest licenced CFD issuers in the five months prior to the commencement of the CFD product intervention order.
- s 37(2)(b), s 47C, s 47E (d) [redacted].

Certificates issued by a qualified accountant

- Under the Corporations Act, accountants can provide a certificate attesting that a person has a prescribed net asset or gross income level. A person holding such a certificate is a:
  - wholesale client for the purposes of Chapter 7 (if they are offered a financial product, other than insurance, superannuation or a retirement savings account product or service) and the financial product is not used in connection with a business; and
  - 'sophisticated investor' for the purposes of Chapter 6D (if they are offered debt or shares): refer ASIC website Certificates issued by a qualified accountant.
- Investors relying on such certificates forgo the protections available to retail clients, in some cases without fully understanding those consequences.
- In 2017, ASIC took action against Kwickie International Ltd for misuse of 'sophisticated investor' certificates.

Comparison with other jurisdictions

- In the US, an individual can qualify as an 'accredited investor' based on:
  - income above $USD200K as single or $USD300K as couple,
  - assets excluding the calculation of primary residence above $USD1 million; and
  - a measure of actual financial sophistication e.g., on the basis of professional status.
- In the UK, there are two categories of wholesale investors:
  - "certified high net worth individuals" who sign a statement certifying annual income above £100K and net assets above £250K (excluding primary residence, pension savings and some other assets); and

- "certified sophisticated investors" who sign a statement acknowledging they have been assessed by a firm as being sufficiently knowledgeable to understand the risks associated with engaging in non-mainstream investment activity.

Previous ASIC statements

- April 2022: ASIC Report 724 cautioned CFD issuers against misclassifying any retail clients as wholesale clients to avoid the CFD product intervention order from applying to those clients.
- December 2021: ASIC's media release detailed Federal Court orders against Mayfair 101 Group.
- August 2021: Deputy Chair Karen Chester answered questions during a PJC hearing in relation to whether the definitions would need to be revised if a compensation scheme of last resort were to be available (in the context of whether certain investors would be more willing to take risks if a CSLR were available).
- November 2018: ASIC's submission to the interim report of the Financial Services Royal Commission (para 98) gave the retail investor definition as an example of complexity.
- August 2017: a PJC hearing considered this issue and ASIC took a Question on Notice in relation to the application of the various definitions and tests. Our response was factual, noting that sophisticated investors may not always have the requisite knowledge to evaluate the risks associated with an investment in complex products.
- July 2017: ASIC media release detailed action taken over sophisticated investor certificates issued by accountants wrongfully attesting to the assets of the investor, and noting instances in which adequate disclosure had not been given to retail investors.
- March 2017: ASIC's submission to the Senate inquiry into consumer protection in the banking, insurance and financial services sector (para 144) noted a concern regarding the test, 'given the ease with which today's investors can satisfy the wealth tests, compared to when the tests were originally introduced', and that for example, we were 'concerned with how the retail client test applies in relation to self-managed superannuation funds'.
- August 2014: ASIC media release clarified the application of the test to SMSFs in circumstances where the trustee of an existing superannuation fund received advice about how to invest the fund's assets.

Independent Review of AFCA (Recommendation 6)

- As part of the Independent Review of AFCA, conducted by Treasury in 2021, industry stakeholders expressed concern that AFCA was not doing enough to effectively prevent sophisticated and professional investors from accessing the scheme (see Final Report, paragraphs 5.45 to 5.47). ASIC made submissions to Treasury about the potential misuse by industry of these exclusions and the need for AFCA to retain an appropriate level of discretion in determining its jurisdiction.
- The Final Report recommended that: *AFCA should exclude complaints from sophisticated or professional investors, unless there is evidence that they have been incorrectly or inappropriately classified*.
- AFCA has recently provided ASIC with updated drafting to their operational guidelines. These propose that AFCA will generally exclude complaints from these types of wholesale clients unless it is reasonably satisfied it would be fair to consider the complaint (including where the complainant was incorrectly or inappropriately classified as a sophisticated or professional investor, or the complainant was not appropriately informed or made aware of the impact of seeking the relevant investor classification).
- While this is unlikely to be a material change to the AFCA scheme requiring formal ASIC approval, we think that any changes should be characterised as a need for AFCA to ensure that their Rules and guidelines are consistent with the law and their fairness jurisdiction, rather than as an endorsement of the current definition of retail client.

ASIC FOI 071-2024

Current Reviews

ALRC Review

- Chapter 12 of the ALRC Inquiry Interim Report A (30 November 2021) invited views on how the definitions of retail client and wholesale client could be amended to achieve greater clarity, simplicity and coherence. The report proposes removing from s 761G product-specific provisions, and the product value and asset and income exceptions. The ALRC also invited comment on the sophisticated investor exception in s 761GA (refer Questions A16 and A17).
- The ALRC Inquiry Background Paper 6 *Reflecting on Reforms – Submissions to Interim Report A* (May 2022) noted there was mixed support for the proposal in respect of s 761G (refer para 190) and divergent views on the criteria or conditions for the sophisticated investor exception (refer para 207).
- ASIC is continuing to engage constructively with the ALRC on its inquiry.

Quality of Advice Review

- In March 2022, the previous Government released an Issues Paper, seeking feedback on how the regulatory framework could better enable the provision of high quality, accessible and affordable financial advice for retail clients. While changes to the definitions of retail client, wholesale client, and sophisticated investor are outside the scope of the Review, the Review is seeking views on whether consent arrangements for sophisticated investors and wholesale clients are working effectively for the purposes of financial advice (para 4.7).
- ASIC is continuing to provide support to the Review and will assist Treasury and Ms Michelle Levy, the independent reviewer, where required.