

3 May 2024

Committee Secretary
Parliamentary Joint Committee on Corporations and Financial Services
PO BOX 6100
Parliament House
CANBERRA ACT 2600

Electronically lodged via My Parliament

Interactive Brokers Australia Pty Ltd (IBA) response to the inquiry into the wholesale investor and wholesale client tests

Dear Sir / Madam,

We refer to the Parliamentary Joint Committee on Corporations and Financial Services' inquiry into the *Corporations Act 2001 (Cth)* (the **Act**) laws and related regulations governing the wholesale investor test for offers of securities (s708 of the Act) and the wholesale client tests for financial products and services (s761G and 761GA of the Act) (the **wholesale investor/client tests**).

Background

IBA is the Australian subsidiary of NASDAQ listed Interactive Brokers Group, Inc. (**IBKR**) which offers Australian domiciled retail and wholesale clients low cost, seamless global market access to more than 150 execution venues across 34 countries trading in 27 currencies via our network of IBKR affiliates. Australian clients increasingly demand global market access for investment and risk management needs, and we are proud to offer an experience that improves the breadth and depth of opportunities available while adding competitive pressure to the Australian pricing landscape, improving financial outcomes for Australian clients.

IBKR brokerage affiliates operate worldwide, leveraging proprietary technology to service individual and institutional clients from over 200 countries and territories through a single unified platform which is carefully configured to comply with local requirements for retail and wholesale clients noting this nomenclature and thresholds vary across jurisdictions. Consequently, IBKR entities have extensive international and domestic experience relevant to the wholesale investor/client tests that are the subject of this inquiry.

Context provided by the Treasury's articulation of the present regulatory framework

The Treasury's Consultation Paper *Review of the regulatory framework for managed investment schemes* (**Consultation Paper**) outlines the historical backdrop, equivalent international regime comparison and rationale for the existing regulatory framework resulting in the present wholesale investor/client tests.

Page 16 of the Consultation Paper has been extracted as Appendix 1 to this letter, serving as a reference point for our submission which is focused on the practical issues faced by investors/clients and financial services providers alike.

IBA submissions on the wholesale investor/client tests

IBA is grateful for the opportunity to provide our perspective on the present regulatory framework, embedded assumptions, practical challenges and proposals to more effectively distinguish between retail 'mum and dad' clients and those who are 'better informed and better able to assess the risks involved in financial transactions' referencing wholesale investors/clients¹.

We understand the principal argument raised by the proponents of revising the wholesale investor/client tests is that the static dollar threshold tests appear inadequate for various reasons, such as:

1. The dollar thresholds set for the individual wealth test has remained unchanged since it was introduced in 2001.
2. Dollar thresholds across the wholesale investor/client tests are not indexed to inflation, or some other measure, to ensure the purchasing power of the dollar thresholds remain relatively constant over time.
3. Perceptions that including the principal place of residence and superannuation balances in the net asset threshold of the individual wealth test has had the unintended consequence of increasing wholesale client eligibility beyond what was anticipated in 2001 and/or may not reflect the net liquid assets available to the client.

While the proposals to increase the static dollar thresholds listed in Appendix 1 (existing wholesale investor/client tests) may on its face be appealing, the simplicity of the idea overlooks the gap in the current framework and the present opportunity available to address structural challenges introduced by the design of these tests to the provision of financial products and services in Australia.

IBA contends that any change to the static dollar-based thresholds in the wholesale

¹ Explanatory Memorandum, Financial Services Reform Bill 2001 (Cth), paragraph 2.27.

investor/client tests is unlikely to address the root-cause of the underlying problem which can be summarized as a conflation of two ideas: financial capacity (ie. Wealth) and financial capability (ie. Relevant knowledge and skills to make financial decisions) of investors/clients.

Financial Capacity versus Financial Capability

The assumptions underpinning the individual wealth test are often simplified to financial capacity being accepted as a proxy for financial capability; however, we consider the actual drivers are potentially two fold (1) that a person with higher financial capacity can absorb greater risk without retail protections, or (2) that such a person has more resources available to them to avail themselves of professional advice in order to understand and evaluate certain products and services. While we consider that there may be merit in both of these points, and there are reasonable arguments that notwithstanding that the figures have been static for some time the persons who qualify still have either capacity articulated above, the mere act of increasing such thresholds is also flawed because it does not recognize financial capability as another critical element necessary to make better financial decisions.

Notwithstanding the observations above, the relationship between financial capacity and financial capability has not been empirically demonstrated and being able to manage financial risks are not inherently dependent, certainly in isolation, on any specific level of individual wealth. Certification by a qualified accountant, as to the existence of the individual wealth necessary to satisfy the test, does not require the accountant to make any evaluation of the financial capability of the client. Unless the qualified account is also a financial adviser, which requires a separate qualification and the completion of a full-time professional year and supervised training, they are unlikely to risk discussing individual financial product or financial service suitability (ie. personal financial product advice) with the client seeking wholesale status.

Practical examples that follow illustrate this spurious correlation promulgated by proponents of increasing the dollar thresholds as a solution to the public policy shortcoming resulting from the existing wholesale investor/client tests.

Scenario 1 – Life event results in a new wholesale investor.

A deceased estate results in the surviving partner of a relationship, with no prior financial experience who ought to be treated as a retail investor, receiving sufficient assets to be classified as a wholesale client under the individual wealth test.

Regardless of the individual wealth test dollar threshold selected, this undesirable public policy outcome will continue to occur unless financial capability is a primary factor to be considered when determining whether to treat an individual as a wholesale

investor/client.

A similar situation emerges with other life event scenarios such as divorce, accident compensation and windfall gains. While the easiest objective test to define the weaknesses and limitations of the individual wealth test should be acknowledged, including that the problems stem from the design of the test itself not the dollar threshold in the Act.

The problem of financial capacity versus financial capability is compounded by the interaction between the various wholesale investor/client tests.

Scenario 2 – Finance graduate treated as a retail investor.

A university graduate with a qualification in finance, commerce, applied finance or economics may not have the financial capacity to meet the individual wealth test; however, the same person's financial capability is entirely ignored and consequently is treated as a retail client even if employed in the financial services industry as a registered financial advisor providing personal financial product advice to retail and/or wholesale clients.

Should the parent of the aforementioned graduate include them as a member and individual trustee of the family self-managed superannuation fund, which has more than \$10 million in assets, then the professional investor test is satisfied pursuant to s761G(7)(d) of the Act, and the individual can be treated as a wholesale client.

The original intention for the Professional Investor definition was to include **financial services professionals**²; however, the drafting of s9 of the Act does not define individuals who are financial service professionals as professional investors. Consequently, Australia has registered financial advisers, and other finance professionals with objective financial capabilities, being classified as retail clients unless they can meet one of the financial thresholds tests or the notoriously underutilized sophisticated investor test in s761GA of the Act.

IBA submits that the professional investor definition should be enhanced to include individuals who are “financial services professionals” on the basis that they have the requisite financial capability and are not equivalent to retail investors/clients.

This is especially true for “financial services professionals” who are employees of a financial services provider, which has overseas precedents such as “knowledgeable employees” as a type of wholesale investor/client in the USA³. Moreover, the equivalent UK elective professional client criteria considers the quantitative test (objective

² Explanatory Memorandum, Financial Services Reform Bill 2001 (Cth), paragraph 2.30.

³ <https://www.sec.gov/corpfin/amendments-accredited-investor-definition-secg>

assessment of wholesale investors/clients) to also include where a client has worked in the financial sector for at least one year in a professional position requiring knowledge of the transactions or services they envisage undertaking⁴.

Scenario 3 – Investor elects to hold assets on a capital account versus a trading account.

A wholesale investor/client opens an account with a financial services provider by demonstrating they qualify under the individual wealth test or the professional investor test. Unbeknownst to the financial service provider, the client then elects to hold their investments on a trading account instead of a capital account indicating to the Australia Tax Office (**ATO**) that they are carrying on a business of share trading⁵. This suggests the client may be ‘carrying on a business in Australia’ pursuant to s21 of the Act, which brings into question whether the small business test is enlivened outside the knowledge or control of the financial services provider potentially excluding the client from wholesale classification.

Clients have no statutory obligation to notify their financials service provider of elections made to the ATO about the nature of their investment activities or their status as a ‘business’ or ‘small business’.

The small business test introduces uncertainty as the objective test criteria is based on an unobservable data point (employee count) defined by s761G(12) of the Act. This undermines confidence in correctly applying the present wholesale investor/client test framework. For example, many Corporate Authorised Representatives of Australian Financial Service Licensees do not have more than 20 employees and evidently do not hold their own license (professional investor test is not satisfied) but require access to the wholesale investor/client classification to operate their businesses.

IBA submits that the interaction between the small business test and the other wholesale investor/client tests, especially the professional investor test, ought to be clarified to reduce ambiguity and better define the circumstances in which a financial services provider is expected be aware of the small business status of an investor/client.

Sophisticated investor test (s761GA)

To the extent a financial service provider is confident an investor/client is not receiving services in connection with carrying on a business, there is a subjective wholesale investor/client test available that has the potential to recognize the financial capability of the client when making investment decisions. In practice this is rarely used as it lacks the

⁴ <https://www.handbook.fca.org.uk/handbook/COBS/3/5.html>

⁵ <https://www.ato.gov.au/individuals-and-families/investments-and-assets/capital-gains-tax/shares-and-similar-investments/share-investing-versus-share-trading>

objectivity of the other wholesale investor/client tests and is subject to legal challenge by clients or disputes at the Australian Financial Complaints Authority (**AFCA**).

Notwithstanding the revised AFCA Rules and Operating Guidelines, effective 1 July 2024, there is still a meaningful subjective component to the wholesale investor/client test as the financial services provider must have 'reasonable grounds', which is an undefined term, for the sophisticated investor assessment. AFCA's own example of misclassification as a sophisticated investor includes scenarios where, "*... there was not a reasonable basis for the Financial Firm's conclusion that the client had the requisite experience*".

IBA submits that the industry would greatly benefit from enhancements to the sophisticated investor test found in s761GA of the Act to better enable clients with a suitable level of financial capability to access wholesale investment opportunities if they choose to do so.

Clear regulatory guidance as to the expectations surrounding applying the sophisticated investor test should be published and financial services providers should be encouraged to preference this test which aims to assess financial capability over other wholesale investor/client tests. Regulators ought to clarify that undertaking a sophisticated investor assessment pursuant to s761GA of the Act is exempt from the personal financial product advice provisions akin to the exemptions in place for responsible lending (unsuitability assessments) and the design and distribution regime.

Conclusion

A wholesale investor/client test framework that actively prioritizes financial capability over financial capacity will improve consumer protection outcomes and enhance the opportunity set available to investors/clients with suitable investment experience, knowledge and skills.

We appreciate the opportunity to provide feedback on the wholesale investor/client tests inquiry. If you would like to discuss our response please feel free to contact Jonathan Pitchford (Compliance Director) by email at [REDACTED], or Ryan Stack (Associate General Counsel) at [REDACTED], and we would be happy to assist at a mutually convenient time.

[REDACTED]
Darren Halse
Managing Director
Interactive Brokers Australia Pty Ltd

Appendix 1

Table 1. Summary of the wholesale client tests (including Corporations legislation references)

Wholesale client test	Description
Product value test s 761G(7)(a) subregulation 7.1.18(2)	Is satisfied when the price for the provision of a financial product or the value of the financial product to which the financial service is related equals or is greater than \$500,000.
Individual wealth test s 761G(7)(c) subregulation 7.1.28 (1) subregulation 7.1.28 (2) regulation 7.6.02AF	Is satisfied where the person has net assets of at least \$2.5 million or a gross income of at least \$250,000 per year in the last 2 financial years and is supported by a certificate given by a qualified accountant ⁶ . The certificate is valid for 2 years after being issued.
Small business test s 761G(7)(b)	Is satisfied where the financial product or service is provided for use in connection with a business that is not a small business (as defined in s 761G(12)).
Professional investor test s 761G(7)(d)	Is satisfied if the client is a 'professional investor' as defined in section 9 of the Corporations Act. This includes where the client is an AFS licensee, body regulated by APRA, entities registered under the <i>Financial Sector (Collection of Data) Act 2001</i> , trustee of a superannuation fund with net assets of at least \$10 million, persons controlling at least \$10 million, an exempt public authority listed entities and body corporates that carry on certain investment businesses.
Sophisticated investor test s 761GA	Is satisfied when a financial product or service is not being provided in connection with a business; and an AFS licensee is satisfied on reasonable grounds that the client has previous experience in using financial services and investing in financial products that allows the client to assess the merits, value, risks and information about the product or service.

The rationale for introducing financial thresholds in the product value test and the individual wealth test assumes that individuals who have the required value in assets or income have the knowledge or experience to understand and take on additional risks or the means to acquire professional advice⁷. Other jurisdictions also use tests that prescribe wealth thresholds and measures of financial sophistication to distinguish between retail and wholesale clients (see Box 3).

⁶ The asset threshold in the individual wealth test includes all assets in the person's name, including their primary residence and superannuation balance.

⁷ Explanatory Memorandum, Financial Services Reform Bill 2001 (Cth), paragraphs 6.19, 6.20, 6.23 and 6.24.