



Australian Government

Australian Law Reform Commission

Senator Deborah O'Neill
Chair
Parliamentary Joint Committee on Corporations and Financial Services
PO Box 6100
Parliament House
Canberra ACT 2600

14 May 2024

Dear Senator

Inquiry into wholesale investor and wholesale client tests

The Australian Law Reform Commission ('ALRC') is grateful for the opportunity to make a submission to the Parliamentary Joint Committee on Corporations and Financial Services' inquiry into the wholesale investor and wholesale client tests in the *Corporations Act 2001* (Cth) ('*Corporations Act*').

This submission is based on findings from the ALRC's Review of the Legislative Framework for Corporations and Financial Services Regulation ('Financial Services Inquiry') and briefly responds to several of the issues raised in the Terms of Reference for the Committee's inquiry. In Interim Report A of the Financial Services Inquiry, the ALRC analysed the wholesale client test for financial products and services (ss 761G and 761GA of the *Corporations Act*) and sought stakeholder feedback in response to two questions.¹

In light of stakeholder feedback and the ongoing review of the wholesale client test as part of the Department of Treasury (Cth) review of managed investment schemes,² the ALRC ultimately did not recommend reforms to the wholesale client test.³ Nonetheless, the ALRC suggests that the Committee consider:

- how the wholesale client test may be simplified to make it easier to apply in practice; and
- whether the wholesale client test could be reformed to achieve greater consistency with its legislative intent.

Historical development

The distinction between 'retail clients' and 'wholesale clients' is critical in the context of Chapter 7 of the *Corporations Act* because it determines when particular protections are available (to 'retail clients') and when a less protective regulatory regime applies (to 'wholesale clients'). The policy rationale for

¹ Australian Law Reform Commission, *Interim Report A: Financial Services Legislation* (Report No 137, 2021) Questions A16 and A17.

² See Department of Treasury (Cth), *Review of the Regulatory Framework for Managed Investment Schemes* (Consultation Paper, August 2023).

³ Australian Law Reform Commission, *Confronting Complexity: Reforming Corporations and Financial Services Legislation* (Report No 141, 2023) [9.41] n 69.

this distinction is that wholesale clients are ‘better informed and better able to assess the risks involved in financial transactions’ and therefore do not need the same level of protection as retail clients’.⁴

When first enacted, retail client status principally attracted disclosure obligations, such as the requirement to provide a Product Disclosure Statement. This reflected the view that retail clients ‘in financial markets require greater protection as they may find it more difficult to, and face greater costs in, gathering the information required to make an informed decision’ and that, conversely, ‘sophisticated participants in financial markets have the resources to enable them to gain relevant information and have sufficient experience and judgment to protect their own interests’.⁵

More recently, however, a wider range of protections have been introduced in respect of retail clients.⁶ These additional protections reflect ‘a recognition of the inherent limits on the ability of individuals to understand and appropriately account for risk when making financial decisions’ and ‘the increased range and complexity of financial products that are now being offered to retail clients such as derivatives and exchange traded funds’.⁷

As a result of these changes, the classification of a person as a retail or wholesale client is of greater consequence than when the tests were first enacted. This is true from the perspective of both a client and a financial services provider, for both of whom there may be incentives to qualify (correctly or otherwise) as either retail or wholesale.⁸

Complexity in the wholesale client test

The definitions of ‘retail client’ and ‘wholesale client’ are complex, with one judge describing them as ‘rather tortuous’.⁹ This complexity stems from two main design features. First, the definition of ‘retail client’ in s 761G of the *Corporations Act* incorporates 25 other defined terms that are variously defined in s 761G or elsewhere.¹⁰ Secondly, exclusions from the definition of ‘retail client’ are dealt with in both the *Corporations Act* and the *Corporations Regulations 2001* (Cth).¹¹ For example, as at 1 November 2021, 29 regulations affected the meaning of ‘wholesale client’ and ‘retail client’, adding considerable volume (8,832 words) to the task of applying the wholesale client test.¹²

As the ALRC noted in Interim Report A, ‘a definition so complex and with many exceptions is vulnerable to regulatory arbitrage’.¹³ If implemented, the legislative model recommended by the ALRC in the Final Report of the Financial Services Inquiry could help to reduce the complexity caused by the use of delegated legislation.¹⁴ Interim Report A also discussed how the treatment of certain products and services in ss 761G(5)–(6A) could be simplified, and existing policy settings maintained, by reframing the definition of ‘retail client’.¹⁵

⁴ Revised Explanatory Memorandum, Financial Services Reform Bill 2001 (Cth) [2.25].

⁵ Competition, Financial Innovation and Investment (Corporate Law Economic Reform Program Proposals for Reform: Paper No 6, 1997) 27.

⁶ Australian Law Reform Commission, *Interim Report A: Financial Services Legislation* (Report No 137, 2021) [12.9].

⁷ *Ibid* [12.10].

⁸ *Ibid* [12.11].

⁹ *Australian Securities and Investments Commission v Westpac Banking Corporation* [2019] FCA 2147 [12].

¹⁰ Australian Law Reform Commission, *Interim Report A: Financial Services Legislation* (Report No 137, 2021) [12.36].

¹¹ A small number of ASIC legislative instruments also have the effect of modifying the definitions of ‘retail client’ and ‘wholesale client’: see *Ibid* [12.32].

¹² *Ibid* [12.30].

¹³ *Ibid*.

¹⁴ See Australian Law Reform Commission, *Confronting Complexity: Reforming Corporations and Financial Services Legislation* (Report No 141, 2023) recs 43–52.

¹⁵ Australian Law Reform Commission, *Interim Report A: Financial Services Legislation* (Report No 137, 2021) [12.33]–[12.48].

Product value and assets/income exceptions

In Interim Report A of the Financial Services Inquiry, the ALRC sought stakeholder feedback on the question of whether the product value and assets/income exceptions in ss 761G(7)(a) and (7)(c) should be removed.¹⁶ The ALRC observed that, contrary to the assumption that underpins the exceptions

experience over the past decade suggests that ... persons who can afford to acquire financial products or services with a value above a certain prescribed amount or whose net assets or income is above certain threshold amounts cannot be presumed to have the requisite knowledge of the product or service to make an informed decision, and are no more inclined to acquire appropriate financial advice than people who qualify as retail clients.¹⁷

The ALRC therefore suggested that ‘consideration should be given removing the exceptions in s 761G(7)(a) and s 761G(7)(c) on the basis that they are not consistent with the underlying policy rationale of s 761G of the *Corporations Act*’.¹⁸ These same arguments support consideration of removing the equivalent exceptions in s 708(8) of the *Corporations Act* in the context of securities.

The ALRC received mixed feedback in respect of whether the product value and assets/income exceptions in ss 761G(7)(a) and (7)(c) should be removed. Submissions in support of doing so ‘generally agreed that [the exceptions] were inappropriate and arbitrary measures for determining the application of retail client protections’.¹⁹ Submissions that did not support doing so ‘cited the potential for increased uncertainty in the classification of clients’.²⁰

A number of submissions supported some change to the product value and assets/income exceptions. These included, for example, applying an indexation method to ensure that the monetary threshold remains appropriate.²¹

The ‘sophisticated investor’ exception

In Interim Report A of the Financial Services Inquiry, the ALRC sought stakeholder feedback as to the conditions or criteria that should be considered in respect of the sophisticated investor exception in s 761GA of the *Corporations Act*.²² Previous reviews and feedback to the ALRC from stakeholders suggested that there is some hesitation on the part of Australian financial services licensees to apply the ‘sophisticated investor’ exception owing to the test’s subjective aspects.²³ In light of this, as well as commentary that expresses concerns about the criteria used to distinguish sophisticated investors from retail clients, the ALRC suggested that ‘further consideration could be given to the basis on which eligibility for this exception is determined to achieve greater consistency with the underlying policy rationale’.²⁴ These same arguments support consideration of removing the equivalent sophisticated investor exception in s 708(10) of the *Corporations Act* in the context of securities.

Submissions in response to Interim Report A expressed divergent views on amending the sophisticated investor exception. These included, for example, incorporating a financial literacy test, incorporating objective (as distinct from purely subjective) criteria, and incorporating a combination of both

¹⁶ Ibid Question A16(ii).

¹⁷ See *ibid* [12.51]; Wai Yee Wan, Andrew Godwin and Qinzhe Yao, ‘When Is an Individual Investor Not in Need of Consumer Protection? A Comparative Analysis of Singapore, Hong Kong and Australia’ [2020] *Singapore Journal of Legal Studies* 190, 201; DC Langevoort, ‘Selling Hope, Selling Risk: Some Lessons for Law from Behavioral Economics about Stockbrokers and Sophisticated Customers’ (1996) 84 *California Law Review* 627, 670.

¹⁸ Australian Law Reform Commission, *Interim Report A: Financial Services Legislation* (Report No 137, 2021) [12.53].

¹⁹ Australian Law Reform Commission, ‘Reflecting on Reforms — Submissions to Interim Report A’ (Background Paper FSL6, May 2022) [199].

²⁰ *Ibid* [201].

²¹ *Ibid* [203]–[204].

²² Australian Law Reform Commission, *Interim Report A: Financial Services Legislation* (Report No 137, 2021) Question 17.

²³ *Ibid* [12.33], [12.69].

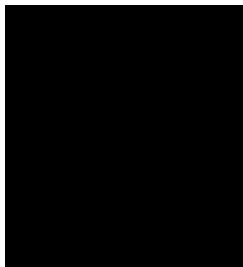
²⁴ *Ibid* [12.69].

subjective and objective assessments.²⁵ Further stakeholder feedback is summarised in the ALRC's Background Paper FSL6.²⁶

Conclusion

We trust this submission is of assistance. If you require any further information, please do not hesitate to contact the ALRC. The action officer is Christopher Ash [REDACTED]

Yours sincerely



Justice Mordecai Bromberg

President

²⁵ Australian Law Reform Commission, 'Reflecting on Reforms — Submissions to Interim Report A' (Background Paper FSL6, May 2022) [208]–[210].

²⁶ Ibid [208]–[213].