20 May 2024

Committee Secretary
Parliamentary Joint Committee on Corporations and Financial Services
PO Box 6100
Parliament House
Canberra ACT 2600

Inquiry into Wholesale Investor and Wholesale Client Tests

The FSC is a peak body which sets mandatory Standards and develops policy for more than 100 member companies in one of Australia's largest industry sectors, financial services.

Our Full Members represent Australia's retail and wholesale funds management businesses, superannuation funds, investment platforms and financial advice licensees. Our Supporting Members represent the professional services firms such as ICT, consulting, accounting, legal, recruitment, actuarial and research houses.

The financial services industry is responsible for investing more than $3 trillion on behalf of over 15.6 million Australians. The pool of funds under management is larger than Australia's GDP and the capitalisation of the Australian Securities Exchange, and is one of the largest pools of managed funds in the world.

The FSC welcomes the opportunity to assist members of the Committee in its consideration of the current wholesale investor thresholds.

The FSC has previously provided submissions to Treasury and the government on potential changes to the wholesale investor test being considered as part of the government's review into the regulatory framework for managed investment schemes.

The FSC wishes to bring to the attention of the Committee some important context around why changes to the wholesale investor test are being considered. We also outline the FSC's proposals to raise the net asset test and make the sophisticated investor test more objective. We submit that these proposals are a balanced approach that brings the test up to date with changing consumer asset profiles, while maintaining important capital flow to wholesale markets relied on by startups and small-cap companies.

Context: MIS review and consumer protection

The review of the regulatory framework for managed investment schemes was initiated by the federal government in August 2023, citing that the regime has not been fully reviewed for 20 years. The purpose of the review is to examine whether the regime remains fit for purpose, with a particular focus on whether changes should be made to enhance consumer protection by reducing undue financial risk for investors. Thus, changes to the wholesale investor test are being considered in the context of a wider review of the managed investment scheme regulatory framework and whether the regulatory framework adequately protects consumers from undue financial risk.

Some stakeholders have suggested that that there needs to be greater legislative restrictions on managed investment schemes sold in the market. The FSC's broad position has been that the framework is working well with major scheme collapses rare. Importantly, the introduction of the Product Intervention Power (in 2019) and the Design and Distribution Obligations (in 2021) has meant that ASIC now has a powerful consumer protection toolbox.

These regulatory tools were introduced after the Mayfair and Sterling Income Trust collapses. Therefore, we do not consider any major changes to the regulatory regime, such as additional ASIC powers, product suitability tests or liquidity requirements are necessary. For there to be any changes to these matters, there would need to be compelling evidence that the current powers available to ASIC are not enough to protect consumers. We have proposed that ASIC use its existing managed investment scheme registration process to collect information to identify where it should undertake risk-based surveillance (eg: a scheme has non-traditional assets or employs a non-traditional strategy).

One area where we do consider there can be modest change made is the net assets limb of the wholesale investor test.

What is the wholesale investor test?

Under the *Corporations Act 2001*, the wholesale investor test has four relevant limbs for individual investors[1]:

- the net assets test ($2.5 million)[2]
- gross income test ($250,000)[3]
- product value test ($500,000) [4], and
- sophisticated investor test

If an individual meets one of these limbs, they can be classified as a wholesale investor, and therefore access wholesale products. Managed investment schemes designed for wholesale clients only may provide more attractive rates of return because of access to different assets and lower fees than funds for retail clients. Companies that raise money from sophisticated or professional investors (concepts which are similar to the wholesale client test, but separate and under the prospectus provisions in Chapter 6D of the Corporations Act) can provide important access to capital for start-up and small to mid-cap firms.

Wholesale clients do not have the benefit of retail consumer protections such as the Design and Distribution Obligations (DDO) regime which obliges financial product issuers to take reasonable steps to ensure distribution is consistent with the target market of the product), bans on conflicted remuneration, dispute resolution processes (subject to some exceptions)[5] and access to a compensation scheme of last resort in certain circumstances.

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[1] There is also a small business test under section 761(7)(b) (the financial product or service is provided in connection with a business that is not a small business) and a professional investor test under section761G(7)(d) (for AFS licensees including superannuation funds)
[2] Section 761G(7)(c)(i), subregulation 7.1.28(1)
[3] Section 761G(7)(c)(ii), subregulation 7.1.28(2)
[4] Section 761G(7)(a) and subregulation 7.1.18(2)
[5] AFCA Rules C.2.2(j) provides that AFCA has discretion not to consider a complaint about a financial service where the complainant is a wholesale client within the meaning of the *Corporations Act 2001*, but is not a Small Business. AFCA may hear cases where the complainant may have been wrongly classified as a wholesale investor.

Why are changes needed?

The FSC considers that there is a good case for updating the net asset threshold in the wholesale client test. When the threshold was first introduced in 2002 it covered around 1% of households. Now, the percentage of Australian households potentially classified as wholesale investors is around 12%. If left unchanged, it would cover a fifth of Australian households by 2033 and a quarter of Australian households by 2043.

Our recommendation and how it strikes the right balance: consideration of the effect on consumer protection and capital markets.

- Net asset test: We have provided support for an **increase in the net assets threshold from at least $2.5 million to at least $5 million including the family home.** Our proposal would bring the number of households classified as wholesale investors under the net assets test to approximately 3%. As an alternative, the assets test threshold could remain at least $2.5 million but exclude the net value (asset less any secured debt) of the principal place of residence. This would bring the number of households classified as wholesale investors under the net assets test down to approximately 5%.
- Income test: We support **maintaining the current income test of at least $250,000** given that continues to cover less than 1% of the population.
- Product value test: We support **maintaining the product value test of at least $500,000**. In 2022, 7.9% of households had access to more than $500,000 in liquid assets, and therefore the ability to meet the product value test, up from around 2.7% in 2002. However, we consider it unlikely that an individual would invest $500,000 into a single wholesale investment or several products at a single point in time if they were not already a high net worth individual.[6]

Any changes to the wholesale investor test must include permanent grandfathering of current clients to prevent a situation where existing wholesale investors are forced to make redemptions or are unable to make additional investments or re-investments in the same product. An appropriate transition period of 2 years should apply. If grandfathering is temporary, for example for 2 years after the test change with a subsequent application of the test, this will not address the issues created for investors currently classified as wholesale investors who may lose this status if new test thresholds are introduced.

We have not provided support for the automatic periodic indexation of the financial thresholds given the uncertainty and cost for the industry it would create, such as ongoing adjustments to compliance systems. We would be open to a legislative mechanism for periodic consideration of increases to the thresholds (for example, every five years) as part of a statutory review of the appropriateness of the thresholds undertaken by the Minister.

[6] NB: Regulation 7.1.17B permits the aggregation of the total amounts invested by a person, an associate of the person and a body corporate controlled and wholly owned by that person with the same product issuer at or about the same time for the purposes of calculating the threshold in the product value test. Regulation 7.1.19(5) permits the aggregation of several financial products where a financial service is provided in respect of several financial products at a single point in time.

We have also not provided support for the introduction of consent requirements for wholesale investors, noting that the consent requirements recommendation in the Quality of Advice review related to advised clients. Extra consent requirements would create additional administrative burdens for Responsible Entities (RE) in the establishment of new internal processes and training of staff for minimal investor benefit.

The FSC recognises that wealth and income are not perfect proxies for financial literacy and sophistication. Having high dollar amounts that cover an appropriate proportion of the population recognises that generally products that have lower liquidity and carry higher risk are more appropriate for investors who have the financial resources to better bear that risk. Having specific dollar value thresholds also helps provide tests that have objectivity and are therefore easier to apply by the industry. It should also be noted that individuals who come into a significant amount of money through inheritance or have experienced high asset value inflation through their family home may not necessarily be financially sophisticated. This underscores the need for the test to cover an appropriate proportion of the population.

<u>Capital raising and the sophisticated investor test:</u>

We note the concern expressed by sections of the start-up and venture capital community over what changing the net assets test threshold may do to restrict access to capital, if it is applied to the sophisticated investor test in Chapter 6D of the Corporations Act as well as the wholesale client test in Chapter 7. However, we submit that rather than avoiding changes to the monetary thresholds for the tests, consideration should be given to changes to the 'sophisticated investor' limb of the wholesale investor test so that truly sophisticated investors with previous experience and appropriate levels of financial literacy to understand the merits and risks with wholesale products can continue to access these products notwithstanding any changes to the net assets test threshold.

Currently, the sophisticated investor test allows an investor to access a wholesale product if the 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. Wholesale fund managers consider this test too subjective (with no regulatory guidance from ASIC on how to apply the test), and as such, they have been hesitant to apply it.

The FSC supports making this test less subjective for AFS licensees to apply, and we think this will help enhance capital flow to wholesale investment products from appropriately experienced investors. The test could have criteria such as previous experience investing in wholesale products, experience or academic qualifications in the finance sector or experience in directing a large business. For instance, the UK has a self-certified sophisticated investor exemption which includes more objective criteria such as having been a company director of a company with at least £1 million turnover, having worked as a finance professional or being a member of a network of angel investors for more than six months.[7]

[7] See *The Financial Services and Markets Act 2000 (UK) (Financial Promotion) (Amendment and Transitional Provision) Order 2024*. Order can be found here: https://www.legislation.gov.uk/uksi/2024/301/made

What has been missed in public discussions is both an understanding of the distinction between the sophisticated investor prospectus test for trading companies and the wholesale client test for other financial products such as managed funds, and that the wholesale investor test is not just the net asset test. Raising the net assets test does not mean there will not be other avenues for truly sophisticated investors to access these investments. Importantly, the sophisticated investor limb under the wholesale investor test can provide an avenue that ensures that appropriate investors continue to have access to these investments.

We attach the research undertaken by PwC and Data Analysis Australia, which provides further details. The FSC would be happy to assist the Committee further.

Sincerely,

Chaneg Torres
Policy Director
Investments & Funds Management