

Inquiry into the wholesale investor/ client tests

AFCA submission to the Parliamentary Joint
Committee on Corporations and Financial
Services

May 2024

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Introduction

AFCA is the external dispute resolution (EDR) scheme authorised under the *Corporations Act, 2001* (Corporations Act) to deal with consumer complaints about financial products and services. This includes complaints from consumers about being incorrectly or inappropriately recorded as a wholesale client by a financial firm member of AFCA and the flow on implications of these actions.

Together, the wholesale investor test for offers of securities (Section 708 of Chapter 6D of the *Corporations Act 2001* (the Act)) and the wholesale client test for financial products and services (Sections 761G & 761GA of Chapter 7 of the Act) establish a regulatory framework for assessing consumers as wholesale clients (referred to collectively as 'the wholesale investor/client tests'). AFCA welcomes the Parliamentary Joint Committee on Corporations and Financial Services (PJC CFS) inquiry into the wholesale investor/client tests and is pleased to provide a submission on this important issue.

Executive summary

The tests play a fundamental role in the financial services law. They operate:

- to set the threshold where key consumer protections—including for product disclosure, best interest duty and complaints handling and redress at IDR and EDR—apply, and
- as a barrier to entry for access to certain high-risk, complex products and wholesale investment markets.

The tests are premised on concepts developed in the 1997 Financial System Inquiry (Wallis Inquiry) and legislated in the *Financial Services Reform Act 2001* (FSR). These concepts include that wholesale clients (defined by reference to wealth, occupational or level of 'sophistication') are 'better informed and better able to assess the risks involved in financial transactions.'¹

The tests and the conceptual framework that underpins them have not been substantially reviewed or updated in almost 30 years.

Under the AFCA Scheme Rules, AFCA has and exercises a discretion to exclude complaints by wholesale clients from its jurisdiction. Predecessor EDR schemes similarly had such discretions. This setting was endorsed in the 2021 Independent

¹ Commonwealth of Australia, Explanatory Memorandum, Financial Services Reform Bill 2001, para 2.27.

Review of AFCA² and reflected in updated AFCA Rules and Operational Guidelines effective 1 July 2024.³

This submission sets out AFCA's complaints experience, the complexity and challenges involved in the application of the tests and the exercise of AFCA's discretion to exclude certain complaints. We also provide examples of investor harms resulting from business models or product distribution strategies that rely on designating otherwise retail clients as wholesale, often to sell high risk/complex financial products that may be wholly misaligned to clients' risk profile, needs and objectives.

Relatively few Australian investors are genuinely wholesale investors. We consider that retail-wholesale regulatory settings that are fit for purpose would include:

- a simple and easy to apply wholesale test with increased financial thresholds
- a bright line test that puts beyond doubt current uncertainty that funds in the regulated superannuation environment - including self-managed superannuation funds (SMSF) - are retail clients.
- clarity that the obligation rests with the relevant financial firm (not the investor) to determine whether a wholesale designation is appropriate to that individual investor; and
- clear record keeping obligations for financial firms when they are designating clients as wholesale.

² [Treasury Review of AFCA - Final Report \(pg. ix, xii and 61\)](#)

³ Consultation on proposed amendments to AFCA's Rules and Operational Guidelines occurred between March and May 2023. Information about the consultation, along with a copy of the updated AFCA Rules and Operational Guidelines commencing effective 1 July 2024 can be found at [Consultation on proposed amendments to AFCA Rules and Operational Guidelines..](#)

1. Complexity of the retail-wholesale tests

AFCA's experience is that the current tests are complex for firms to apply and communicate, AFCA to apply in complaints handling and difficult for consumers to understand.

AFCA assesses each investor complaint we receive to establish whether we have jurisdiction to deal with it under our Rules and will generally exclude complaints where the investor is appropriately classified as a sophisticated or professional investor. However, we will not exercise our discretion to exclude a complaint merely because it is submitted by a wholesale client.

In cases where jurisdiction is uncertain, AFCA will consider the application of the relevant 'wholesale' test. Below we set out our observations on the key issues and challenges that arise under current settings.

1.1 Wealth tests

AFCA's experience of the wealth test is in line with observations from earlier reviews which noted that more Australians will meet the wealth test in sections 708(8)(c) and s761G(7)(c) and regulation 7.1.28 of the *Corporations Regulations 2001* simply because of the appreciation of assets and household wealth over time.⁴

We support this analysis, including that the threshold for the wealth tests are too low. However, we also note that wealth is not a proxy for sophistication and the wealth from ownership (or inheritance) of property in a metropolitan capital, should not—on its own—be sufficient to suggest wholesale designation is appropriate.

AFCA supports increasing the wealth test; however, we consider that any updated test should exclude superannuation and the family home.⁵

1.2 Sophisticated investor test

The policy rationale behind the sophisticated investor test is that an investor is sufficiently experienced and sophisticated so as not to require retail product disclosures. Importantly, this includes that an investor can assess the risks, including of potential losses arising from their investment in what may be a complex, high risk wholesale product.

Under current settings, AFCA's experience is that this test tends to be infrequently relied upon, relative to the wealth test. Where it is relied upon, it is often misapplied. Firms may not consider all the relevant criteria or may fail to perform a sufficiently rigorous assessment of risk profile and financial tolerance. We consider 'tick a box'

⁴ Wholesale and Retail Clients Future of Financial Advice Options Paper January 2011

⁵ We note the submission by the Financial Services Council recommended an increase to the wealth test to \$5M and to include the family home or maintain the \$2.5M threshold and exclude the family home.

assessments to be insufficient and our observation is that firms' tend to prefer 'bright line' tests such as the wealth test which is simpler and easier to apply over more ambiguous, qualitative assessments such as the sophisticated investor test.

Where there are multiple and optional tests to apply, our observation and experience is that firms will default to the test that is the simplest and easiest to apply.

1.3 Practical application of the tests

Each stand-alone wholesale test has material limitations. They also assess qualitatively different but separately relevant factors to an overall assessment as to whether wholesale designation is appropriate to a given client.

The wholesale client test serves a dual purpose, as:

- a barrier to entry: helping a firm to satisfy itself that a client is genuinely wholesale, ensuring that only those clients access certain products/ markets; and
- a threshold: so only those investors with sufficient *financial tolerance* (e.g. ability to bear capital losses); and *risk tolerance* (e.g. understanding of the risk they are assuming), including risks that may flow from foregoing important product governance protections, disclosures, and access to dispute resolution (IDR and AFCA).

Where there are multiple tests, each applying different thresholds, there is a risk that a change to one test will shift firm behaviour toward the other. For example, an increase to the wealth test, may result in more reliance on the more subjective 'sophisticated' client test.

AFCA considers that a single test with two limbs: a *wealth* limb and *financial/ risk tolerance* limb may more effectively respond to the policy objective, reduce uncertainty for firms and ensure wholesale designation properly applies to only those clients who have sufficient assets as a buffer to capital loss and are genuinely capable of assuming the risks.

AFCA supports retention of the professional investor test as it is generally well understood and applied.

1.4 Self-Managed Superannuation Funds

A key area of uncertainty and risk relates to the classification of trustees of Self-Managed Superannuation Funds (SMSF) as wholesale clients. Under the Corporations Act:

- where the financial service relates to a superannuation product, a trustee of a SMSF is classified as a retail client unless the fund holds net assets of at least \$10 million at the time the service is provided ('net assets' test).
- where the financial service does not relate to a superannuation product, the general test for determining whether the trustee is retail or wholesale applies (the trustee will be a wholesale client if the trustee has a certificate from a qualified accountant stating they have net assets of \$2.5 million or if the value of the investment is at least \$500,000) ('general test').

There is both regulatory uncertainty and inconsistent application of each of these tests. AFCA has seen many cases where financial firms have recorded the wholesale status of SMSF trustees, based on the general test, rather than the net assets test. This can result in poor and often inconsistent outcomes for trustees and uncertainty for firms as to the correct application of the respective tests.⁶

AFCA has also seen many cases of poor advice to consumers to establish and rollover a modest pool of superannuation savings into an SMSF as a vehicle to access wholesale products or markets (see case study 1 below).

Given the policy purpose and public interest in Australian's retirement savings, we consider it essential that there is clarity for all parties as to the regulatory setting for SMSFs. AFCA considers that retail protections are essential to superannuation regardless of the vehicle used to manage Australian's superannuation savings.

AFCA supports a bright line test that puts beyond doubt current uncertainty that funds in the regulated superannuation environment - including self-managed superannuation funds (SMSF) - are to be treated as being held by retail clients.

1.5 Assessing clients individually

AFCA has considered complaints where the trustees of the SMSF are a couple and while one trustee has been assessed under the requisite requirement to be recorded as a wholesale trustee, this has been unilaterally applied to all trustees. AFCA's view is that for a corporate trustee to be recorded as a wholesale client, each trustee (or each director of a corporate trustee) must meet the requisite requirements of the wholesale investor test.

Any updated test should require that any assessment of a wholesale client's status should be done for each member of a couple.

⁶ [ASIC Media Release \(14-191MR\)](#)

2. Application of the tests in individual complaints

The application of the various wholesale tests is a live issue in complaints at AFCA. The following cases demonstrate how the complexity, uncertainty and risks manifest for individual investors.

We also reference systemic issues cases identified from complaints and referred to ASIC given evidence of misconduct and the broader consumer detriment that can result where firms misclassify investors.

Case study 1: Retail clients misclassified as wholesale

Determination number: 636044

The complainant was a corporate trustee of its self-managed superannuation fund (SMSF). The complaint was lodged by the directors of the corporate trustee about the SMSF's investment of \$75,000 in a wholesale invitation only fund (the fund) under an information memorandum issued by the financial firm. The financial firm was also trustee of the fund.

The complainant said:

- it was unaware the fund was intended for wholesale investors
- it did not meet the wholesale criteria when it initially invested in the fund
- it is seeking a refund of its investment of \$75,000.

The complainant was adamant it was a 'retail' investor and did not have the financial circumstances to be considered a wholesale investor. The complainant says the SMSF held approximately \$200,000 at the time it invested in the fund. The complainants said their only asset was their family home and provided information to substantiate their financial circumstances at the time.

The financial firm did not respond to AFCA's request for information and made no contact with AFCA during the course of the complaint. Given the financial firm's lack of engagement with this complaint, the ombudsman considered it appropriate to draw an adverse inference for the failure to provide information about how it classified the complainant as a wholesale investor.

The ombudsman concluded that neither of the complainants' financial circumstances met the wholesale investor thresholds and that the financial firm breached its obligation by failing to show it ascertained the complainant's investor status. The ombudsman was also satisfied that if the financial firm had attempted to ascertain the complainant's investor status, it would have concluded the complainant was a retail investor and unsuitable for a wholesale fund.

Definite systemic Issue: This matter was referred to our systemic issues team who reported the financial firms conduct to ASIC.

Case-study 2: Inappropriately recording the trustee as a wholesale client

Determination number: 907346

The complainant was a corporate trustee of a SMSF, with the complaint being lodged by one of its trustees. The complainant said that the financial firm provided advice to invest in shares of a company's initial public offering that was only available to 'sophisticated' investors.

The ombudsman concluded that the financial firm did not demonstrate that it met the requirements (including the provision of a written statement required by s708(10)(c)) to record the trustee as a wholesale client.

The ombudsman also found that as both share application forms from were completed on behalf of the corporate trustee, not the trustee in his personal capacity, it was important to assess whether this entity met the eligibility criteria to invest. The trustee was not the sole director of the complainant. Based on the ombudsman's finding, they concluded that the trustee who lodged the complaint (and assessed by the financial firm) lacked the requisite control of the complainant to have his classification as a wholesale client flow to the complainant itself (even if properly established). The financial firm therefore should not have facilitated or accepted the application and did so in breach of its obligations to the complainant.

Case study 3: Failure to inform clients about the implications of wholesale classification

Determination number: 841469

The complainants were trustee directors and beneficiaries of a SMSF. The complainants allege that an authorised representative of the financial firm, amongst other issues raised, failed to explain the implications of being a wholesale client.

The complainants said they were not aware of the significance of being as retail clients until several years after being placed in wholesale investment when they received a document titled 'Your Investor Risk Profile'. It set out the advantages and disadvantages of being a wholesale client. It referred to an adviser being obliged to provide a retail client with a financial services guide and a statement of advice. It referred to the obligation to provide a retail client with a product disclosure document. It also referred to the retail client's right to complain to AFCA.

The document also had a place for signing if the complainants elected to be treated as wholesale clients. Neither of the complainants signed the election.

The complaint progressed to an ombudsman determination in which the ombudsman concluded that the authorised representative engaged in misleading conduct by not explaining the wholesale client implications.

Case study 4 - Systemic Issue – Failure to adequately assess client’s suitability to be classed as a wholesale client.

AFCA’s systemic issues team was referred multiple complaints that raised multiple issues about a financial firms conduct. One of these issues was that the financial firm was not adequately assessing their client’s suitability to be classed as wholesale clients. From the referred complaints, there were several examples of this conduct.

In one case, a retail client was not aware that the financial firm had obtained a wholesale client certificate for the purposes of offering the client a wholesale product. The client was not made aware of the certificate, that they had been classed as a wholesale client and placed into a product that was for wholesale clients only.

In concluding our investigation, in our view, the financial firm did not show that it was adequately assessing a client’s suitability to be a wholesale client and there had not been adequate changes to policy procedures and training to prevent the reoccurrence. In these circumstances, the conduct was reported to ASIC as an unresolved systemic issue.

3. Intended and unintended consequences

Under the current tests, there is a very real risk that retail investors can readily access high risk, complex and /or leveraged products that are not suitable for them. AFCA sees many cases of significant retail investment losses resulting from such investment decisions including investments in products such as Over the Counter Contracts for Difference (CFD), for example.

It is not the case that the Australian market or the operation of the wholesale tests presents a material barrier to Australian investors availing themselves of the opportunity to purchase complex, risky products and bearing both the up and downside risks where they are in line with their risk appetite and tolerance.

For the minority of genuinely wholesale investors, we support settings that clearly and simply establish the threshold. We recognise that changing policy settings change incentives and have observed how fixed monetary limits can deliver perverse outcomes. For example, we have seen cases where the \$500,000 investment limit under the ‘general test’ has incentivised firms to recommend investments larger than they may otherwise have, simply to gain wholesale access.

We consider an investor’s financial tolerance for loss to be an essential consideration in the application of any updated wholesale test given the material differences in financial tolerance between an investor who can absorb a financial loss of \$300,000 from an investment pool of \$500,000 as opposed to an investment pool of \$5 million.

While AFCA does not have a view on the appropriate increased monetary limit under an updated test, we do not support inclusion of the family home or superannuation. The policy rationale for the wealth test is that an investor has sufficient assets behind them to recover from any losses. We do not consider a threshold that puts the family home or retirement funds held in the regulated superannuation system at risk, to be an appropriate one.

3.1 Responsibility for 'wholesale' designation

Regardless of where the threshold is ultimately set, it is essential that the adviser retains the records and responsibility for proactive engagement and discussion with their client as to their retail/ wholesale status.

We note earlier reviews contemplated regulatory settings involving upfront client consents excluding future access to IDR and to AFCA⁷. Such an approach would shift the onus from the financial firm—who is best placed to make the assessment and understand the implications of wholesale designation—to the consumer/ investor.

Complaints AFCA has dealt with (including in the examples above) include cases where designated wholesale investors lacked understanding or awareness about:

- how the wholesale product or scheme invested or worked in practice
- the related and underlying risks of the product
- the fact they had been classified as a wholesale client, and
- the reduction in consumer protections associated with the classification.

From a complaints-handling perspective, it is the individual context in which client consent is sought and obtained that determines whether a particular consumer genuinely understood the implications of and agreed to their classification.

If some form of consent model were contemplated, it is essential that it does not preclude investors from access to IDR and EDR. A decision or assessment about whether a client meets the definition of a wholesale client should not be left to investor attestations and passive acceptance by the advice provider or responsible entity. Such a decision should be an active decision following an appropriate engagement and assessment with the financial firm maintaining appropriate records.

This assists financial firms to satisfy themselves that they have complied with their obligations and supports any future assessment by AFCA of its jurisdiction and to identify any substantive issues about the consent or whether the client met the relevant wholesale test. It also supports AFCA's systemic issues role to identify and report any systemic issues we identify in complaints handling to the regulators.

Record keeping obligations should cover how each client (where the client is a couple) meets the relevant test; and firms' engagement with their client having regard to their specific circumstances including experience, understanding of risk and financial tolerance to losses.

⁷ Recommendation 11: Quality of Advice Review Final Report