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# Raising the bar

At 23 years old, the wholesale investor tests are no longer applicable to a booming Australian economy. If the thresholds increase, what consequences will financial advisers dedicated to sophisticated investors be forced to deal with? **Karren Vergara** reports.

When Perth-based Sterling Group collapsed five years ago, 130 victims – most of whom were retirees and seniors – lost $18.6 million of their life savings.

The retirees signed up to a complex rent-for-life scheme where they made a one-off payment in exchange for a home they rented for a 40-year period. The funds were then invested into a trust that generated income to pay their rent.

One retiree's understanding, when asked in a victim action group survey, was that their funds were used for aged care property development secured against the land and property under development.

"Minimum risk was involved as the funds used for development of such properties were leased back from the original owners," the retiree said.

What the promoters didn't tell them was the fact that the scheme was extremely high risk. They deliberately targeted retirees with little to no level of sophisticated investor knowledge. Nine out of 10 victims admitted to this. They also didn't know they invested in a managed investment scheme (MIS).

When Sterling became insolvent, many retirees were unable to make lease payments. Some were left homeless. Sterling's collapse, amongst other things, reinforced just how easy it is to pass off investors as sophisticated when they have no business of being one.

The government imposes five tests to determine if an individual is in fact a sophisticated or wholesale investor. By the same token, the tests protect retail investors and give wealthy investors freedom to undertake more complex or sophisticated strategies under the principal of *caveat emptor*.

The tests haven't been updated since 2001, defying indexation – unlike the transfer balance cap (TBC) which came into effect on 1 July 2017 at $1.6 million – was recently indexed to $1.9 million.

When the tests were legislated, sophisticated investors represented only 1.4% of the population or 104,000 (Figure 1), an Australian National University research paper shows.

By 2018, this jumped to 9% or 853,000 of households that had at least one person who qualified. Three years later, 11.3% of Australians or 1.09 million were deemed wholesale investors. Over the next decade, this proportion is set to double.

Ben Marshan[01], principal of Ben Marshan Consulting, says the framework was designed for very knowledgeable, experienced, and wealthy individuals who understood and could take the level of risk associated with a wholesale investment.

"It is now out of sync with the economy," he says.

Most Australians do have a simple if not basic understanding of the risks borne by financial products, markets, and investing. Survey after survey paint an even bleaker picture of how basic or low their financial literacy levels are.

"The way house prices and superannuation, for example, have increased in value over the last 20 years, many Australians who are being offered wholesale investment opportunities don't have the sophisticated understanding of what these financial offers are, the risks they carry, and importantly the decreased level of protection that wholesale investments provide," he says.

The government has fired off several warnings that the wholesale investor tests are due for a shake-up.

In the October 2022-23 Budget, Treasury said it would review the regulatory framework – including the thresholds – specifically for MIS and launched consultations last August.

On March 20, it took this further by launching a Parliamentary Joint Committee on Corporations and Financial Services inquiry into the entire wholesale investor test.

Key facets such as application of the tests in practice, legal requirements, and consequences for investors will all be under the microscope. According to the terms of reference, the government will look at the proposals to change the wholesale investor tests, the ensuing consequences, as well as the costs and benefits.

TownsendCobain Private Wealth partner Tim Townsend[02] sees the potential changes as a positive and overdue to some degree.

"I think it's an adjustment that is obviously required, not having been addressed for so many years now. The protection of investors is

**01:**
**Ben Marshan**
principal
Ben Marshan Consulting

**02:**
**Tim Townsend**
partner
TownsendCobain Partners

**03:**
**Spiro Premetis**
executive director of policy and advocacy
Financial Services Council

an important element of the government's role and the need to keep moving with the increase in wealth in society is a necessary shift," he says.

While thresholds delineate the investors that have enough assets and income who can take on the risks of wholesale investing, they do not answer one burning question: Is the investor financially knowledgeable enough to invest in wholesale products?

## Face lift

Modernising the wholesale investor test by lifting the asset threshold to $5 million including the family home will help ensure wholesale products can only be accessed by those who are able to bear the financial risk and are likely to have a more sophisticated understanding of financial matters, says Financial Services Council (FSC) executive director of policy and advocacy Spiro Premetis[03].

"The FSC recognises that wholesale investors are a vital part of Australia's capital markets, however we would support the government updating the threshold so that only genuine sophisticated investors fall within this category," he says.

All in all, the FSC is pushing for:

- Retaining the product value test of $500,000
- Increasing the individual wealth test financial thresholds either to:
  - Increase to $5 million (including the family home) or maintain at $2.5 million (exempt the family home); and
  - Retain the gross income test at $250,000
- Improving the sophisticated investor test through regulatory guidance or a safe harbour
- Periodic review and no indexation, and
- A two-year transition and grandfathering of existing clients.

Financial advisers, in many aspects, are gatekeepers to sophisticated investment opportunities.

There are currently 2056 AFSLs that specialise in wholesale clients (as at March 1), according to ASIC data. This is about 50% less than the 3977 AFSLs that service both retail and wholesale clients.

Those opposed to lifting the thresholds predict dire consequences for the high-net-worth (HNW) specialists that could result in upending business models, undertaking new professional qualifications, or quitting advice altogether.

Morgans Financial head of wealth management Terri Bradford[04] warns changes to the thresholds for MIS could result in many advisers who structured their business on a wholesale-client-only model lose their client base and business.

"Advisers have already gone through substantial change due to the introduction of FASEA education requirements. The industry has suffered significant loss over the past few years in terms of advisers leaving the industry," she wrote in response to the MIS consultation.

Further, HNW firms typically hold the key to unique wholesale opportunities that retail clients are not privy to. Bradford points out that advisers structured their businesses to specifically meet such demand.

"Changing the current regime may impact what products and strategies clients can invest in," she says.

"It may also result in clients having to sell out of their wholesale products, which could result in other complications such as incurring tax and other transactional costs."

At TownsendCobain, about 70% of clients are wholesale investors.

"We treat them as retail investors," Townsend says.

"Part of the reasoning behind that is it's very dangerous in a practice to have different classes of clients that get different levels of information. How easily could you get somebody in the wrong group at some point in time?"

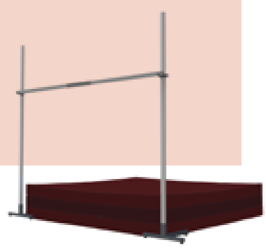
In servicing the retail cohort, Townsend admits that the compliance piece can be burdensome.

"But once processes are in place to support it, it's relatively – I wouldn't say easy but doable – that you can treat all people with the same level of knowledge when engaging them," he notes.

Co-chief executive of regulatory risk consulting firm MIntegrity Amanda Mark[05] urges advisers specialising in the HNW segment to get on the front foot.

They can start by leveraging data at their fingertips and analyse the information about their clients, she says, by distinguishing who falls into the five categories.

> *... it's very dangerous in a practice to have different classes of clients that get different levels of information.*
> **Tim Townsend**



"Then in the individual wealth category take it a step further to look at is the family home included in the net assets? How many clients just earn over the $250,000 per year?" she says.

"Once you know where your current clients are, then depending on what changes come in, you will know which changes will have the greatest impact."

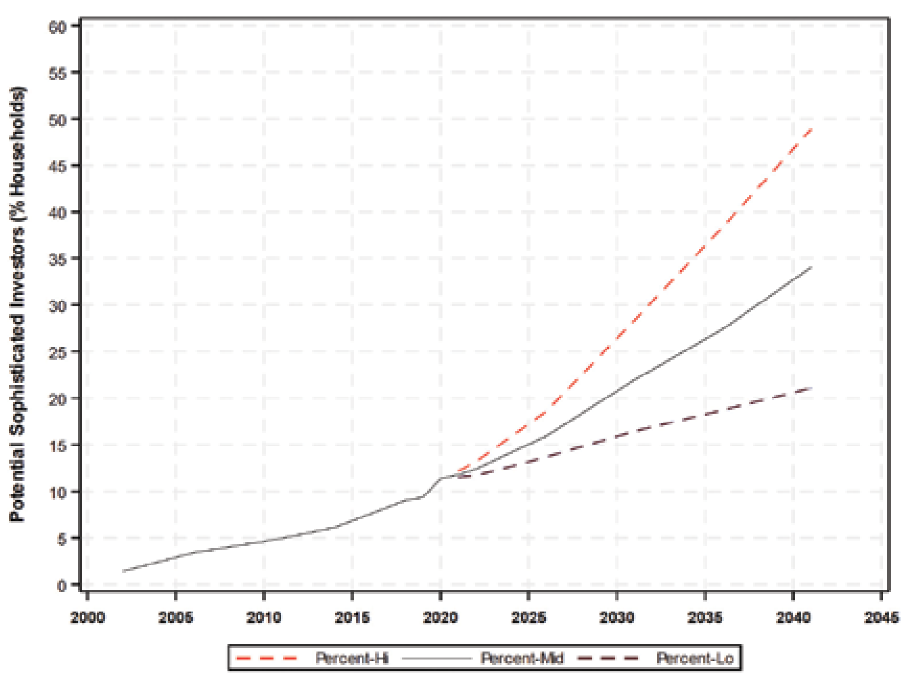
Advisers should also undertake best and worst-case scenario analysis if the thresholds increased and if the family home was excluded in the tests.

"If gross income was raised to $300,000 or $500,000 how many clients would be impacted? If this is only a small percentage of their clients then the impact will be marginal; if this is the majority of clients then this could be very challenging for a firm," she says.

If the worst-case scenario befalls an HNW-focused firm whereby several clients are suddenly deemed retail investors, an off-boarding process will eventuate and consequently revenue will take a hit.

"Firms can prepare now by looking at this data to see where they may be seriously impacted and look at changing their strategy on client acquisition," Mark says.

**Figure 1: Sophisticated investor household population (%)**




Source: HILDA, ANU Centre for Social Research and Methods

**04:**
**Terri Bradford**
head of wealth management
Morgans Financial

**05:**
**Amanda Mark**
co-chief executive
MIntegrity

**06:**
**Pamela Hanrahan**
professor of commercial law and regulation
UNSW Business School

## Diversification risk

Tobias Lewis, the managing director of wholesale investment manager Marquette Properties, is urging the government to leave the tests alone.

Increasing the threshold from $2.5 million net assets to $ 4.5 million will have "devasting effects on our existing investor base, our assets and our capacity as a business going forward," he says.

"The proposed changes would dramatically alter how we operate and service our investor base, as well as our existing investor's current holdings. For example, the staff within our own business would no longer qualify for wholesale designation under the changes."

By and large, Lewis argues a large pool of existing wholesale investors will be prohibited from participating in investments that they enjoyed in the past. Conversely, financially competent and savvy investors will be forced into retail offerings with commensurate higher costs and lower returns.

Consumer choice, diversification, and access to deal and investment flow would also be severely impacted, he predicts.

In a whitepaper that debates the changes, HopgoodGanim partner Nicole Radice and associate Rebecca Rutland agree that upping the thresholds will disadvantage investors and reduce consumer choice by forcing otherwise financially competent individuals into retail offerings with less risk and lower returns.

"This, in turn, may have a flow-on effect for start-ups and other micro-cap companies seeking to raise funds in Australia," they write.

If the tests remain as is, however, the lawyers say that many more Australians will have access to potentially more lucrative investment opportunities, such as unlisted real estate, private equity, and seed rounds for start-up entities – but give up certain consumer protections.

"From a policy perspective, such a trade-off is generally only acceptable if investors have a sufficient level of financial sagacity to compensate for the lack of safeguards, such that they can make their own informed investment decisions," they say.

Pamela Hanrahan[06], a professor of commercial law and regulation at UNSW Business School, warns that any change to the retail and wholesale distinction not only has a significant impact on the broader financial services industry, but it will be expensive to implement.

"It will require significant systems changes. It will also result in some households or small businesses that are currently considered wholesale falling out of that category. This will inevitably lead to complaints from both sides, and to political complexity," she says.

Grandfathering existing wholesale clients will also be a given.

Hanrahan suggests abolishing the $500,000 product value test. Having spent years in the senior ranks of corporate regulator ASIC, Hanrahan saw how this particular test drove poor consumer outcomes.

In one case, a financial planner at a bank advised an older, widowed client to liquidate all her investments to acquire a structured product issued by the bank that required a minimum $500,000 investment. When the product failed, she was undiversified and lost everything.

Hanrahan found similar practices prevalent in several Gold Coast mortgage funds, where existing clients in a registered MIS were individually targeted and duchessed by the issuer to move all their wealth into the product that promised but did not deliver lower costs or superior returns.

"The problem again is lack of diversification. This practice was particularly prevalent when the destination product purported to offer an annual percentage rate of return (usually expressed as a percentage with an asterisk, indicating it was nothing but an empty aspiration) and therefore was seen as a potential income stream," she wrote in her submission.

"It is true that financial services laws have been tightened since 2008, but the risk remains from unscrupulous MIS issuers who can argue (under this test) that the client is wholesale at the time the product is acquired and therefore that, for example, the DDO laws do not apply."

Venture capitalist Stew Glynn, a managing partner and co-founder of TEN13, which invests in early-stage start-ups, worries about a chunk of investors who will lose access to this asset class.

"They are not your average retail investors who fall victim to get-rich-quick scams," he wrote on LinkedIn.

"They are genuinely passionate about investing in emerging companies, and their knowledge and expertise can greatly benefit these young companies on their path to success. Additionally, they can also reap the rewards of having their own hard-earned capital invested in these companies when they do succeed."

One major criticism of the tests is that they use wealth as a proxy for financial literacy.

Can the government truly use a price tag to measure financial understanding and sophistication?

And what about children who end up inheriting a vast amount from their parents?

Marshan, like many, might understand the risks of making investment decisions in the wholesale space, but would not meet the threshold tests.

"Therefore, I'd be inclined to argue that I should be able to prove that I can take advantage of those investment opportunities even if I have less net assets or income than the thresholds," he says.

Then there are those like his parents, who meet the thresholds between their superannuation and property value, but don't have the same level of knowledge to confidently invest.

He asks: "Should they be given free rein to lose the proper financial protections on an investment they don't properly understand?" FS

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**4k**

*There are 3977 AFSLs that service retail and wholesale investors, 50% more than wholesale investor-focused AFSLs.*

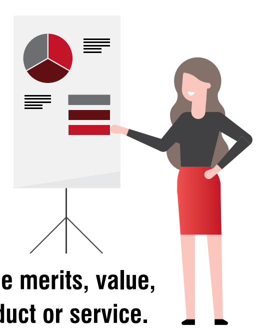
**A wholesale client is classified the following ways:**

**Small business test:**
The financial product or service is provided for use in connection with a business that is not a small business.

**Individual wealth test:**
A person either has net assets of **$2.5 million** or gross income of **$250,000** p.a. for the last two years as verified by a professional accountant's certificate (which lasts for two years).

**Professional investor test:**
A person has assets of at least **$10 million.**

**Product value test:**
Investible amount is **$500,000-plus.**



**Sophisticated investor test:**
When an AFS Licensee is satisfied on reasonable grounds that a client has previous experience in using financial services and investing in financial products and can assess the merits, value, risks, and information about the product or service.