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Assessing Options for Modernising the Wholesale Investor Test

Financial Services Council

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Executive summary

Key findings

- **Benefits of wholesale investment products**: Wholesale investment products provide financially literate and sophisticated individual investors access to a broader range of financial products that have higher risk-adjusted returns but without the level of regulatory protection that retail investors receive.
- **Need for reform of individual wealth test thresholds:**
  - The thresholds for the wholesale investor 'individual wealth test' - net assets of $2.5 million or gross income of $250,000 per year in the last two years - have not changed since it was introduced in 2001.
  - While an estimated 1.5% of households qualified when it was first introduced,[1] Data Analysis Australia estimate 11.7% now qualify; an eight-fold increase. If left unchanged, this is likely to grow to 19.1% in 2033 and 25.5% in 2043.[2]
- **Options for reform considered in this paper:** The Financial Services Council (FSC) has proposed that any changes to the wholesale investor test thresholds include grandfathering the current arrangements so current investors are not forced to change. Options proposed by the FSC included in this report include:
  - **FSC proposed threshold changes**: making changes to the threshold so the eligible population reduces to between 3% (if the net asset test were changed to be $5 million including the family home) and 5% (if the net asset test were changed to be $2.4 million excluding the family home), bringing the threshold in line with the current environment (Option 1)
  - **Indexing thresholds for inflation**: adjusting the current thresholds for inflation since 2001 and indexing annually thereafter (Option 2), or
  - **Periodic re-assessment of thresholds by the Minister**: the Minister periodically re-assessing the thresholds upon consultation with industry (Option 3).
- **Options analysis**: An options analysis was undertaken by PwC. This assessed the relative impact of the proposed options on categories of benefits (consumer protection) and costs (costs of implementation, impact on access to higher risk-adjusted returns and impacts on the ability to raise capital). Implementation costs were informed by a survey of fund managers and advisors.
- **Results of the analysis**: Overall Option 1 rates higher than the other two options. Option 1 delivers higher benefits by providing greater consumer protection to a larger pool of potential investors, and entails lower costs as it only includes a one-off change with no requirement for periodic review or annual changes.
- **Importance of grandfathering**: If grandfathering of current arrangements is not included, all options become higher cost. Not grandfathering will increase complexity, require the re-classification of all existing investors, causing additional customer engagement, force redemption for investors who no longer qualify and impact the ability for markets to raise capital.

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1 Analysis based on the 2002 HILDA survey.

2 Analysis based on the 2018 HILDA survey.

1 Background

1.1 Context to the wholesale investment market

Wholesale investment products form an important aspect of capital markets, offering investors potentially higher returns at the cost of a higher risk. It is important that investors understand and can afford the potential losses associated with these higher risks. It is for this reason that it is vital for investors in these products to have a level of financial literacy that allows an understanding of these risks.

Australia uses a combination of wealth thresholds and measures of financial sophistication to distinguish between retail and wholesale clients. The wholesale investor test was first introduced as part of the *Financial Services Reform Act 2001* which inserted a distinction between retail and wholesale clients into the *Corporations Act 2001*. The wealth and income thresholds that were implemented as part of the wholesale investor test have not been amended since the introduction of the wholesale investor test.

Recognising the significance of the managed funds industry, which includes total assets to the value of about $2.8 trillion,[3] the Australian Government is undertaking a review of the regulatory settings for managed investment schemes (the Review). One consideration in the Review is the thresholds used to determine whether the individual wealth test thresholds are relevant in today's environment and if they provide an adequate benchmark to determine if an investor might be a wholesale client.

1.2 Current state of the wholesale investor test

Under the current wholesale investor regime, an investor must satisfy any of the following four objective eligibility tests or one subjective eligibility test:[4]

- **The product value test**: The product value test automatically applies for investments in excess of $500,000.
- **The individual wealth test**: A person satisfies the individual wealth test when they have obtained a professional accountant's certificate stating that the client has:
  - net assets of $2.5 million, or
  - or gross income of $250,000 per year in the last two years.
- **The professional investor test**: A person satisfies the professional investor test if they have or control assets of at least $10 million.
- **The sophisticated investor test**: A person satisfies the sophisticated investor test when an Australian Financial Services (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 small business test**: The small business test is used when the financial product or service is provided for use in connection with a business that is not a small business.

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3 ABS(2023), Managed Funds, Australia, available at https://www.abs.gov.au/statistics/economy/finance/managed-funds-australia/latest-release#key-statistics

4 *Corporations Act 2001*

1.3 Benefits of wholesale investment products

Wholesale investments offer a range of benefits including:

- access to a broader range of investment opportunities, which have the potential to generate higher returns for investors
- better diversification of investors' portfolios, which spreads the risk and reduces the impact of being exposed to a single product
- reduced costs of meeting the compliance and regulatory requirements in the retail investment market, which are ultimately passed on to the individual investor
- lower management fee associated with wholesale investment products compared to retail investments, which reduces the overall cost for investors
- access to a wider range of financial advice firms that may specialise in wholesale investment products that are not open to retail investors
- easier access to capital for businesses including those who need private investment capital at the early-stage start-up phase. Small-cap businesses (with market capitalisation of up to $100 million) and mid-cap firms (market capitalisation $100 million to $500 million) rely on capital raised through investments by sophisticated and professional investors.[5]

1.4 Purpose of this report

This report is part of the research being undertaken by the Financial Services Council (FSC) to build a strong, data-informed evidence base to allow for input into the Australian Government's Review. While the Review is considering broader issues in the regulatory framework for managed investment schemes, this report only considers reforms to the thresholds that determine whether an investor is a wholesale client. Specifically, this report aims to assess the:

- current thresholds for the individual wealth test and product value test for their coverage and appropriateness in today's context
- potential costs and benefits of the proposed options to understand the relative impact of the proposed options.

The analysis in this report is limited to individual investors and as such, the professional investor test and small business test are out of scope as they relate to institutional investors.

1.5 Overview of previous work undertaken

A range of reviews have been previously completed to consider changes to the wholesale investor test. A summary of these reviews and research is included below.

Wholesale and Retail Clients – Options Paper (2011)[6]

As part of the *Future of Financial Advice* (FOFA) reforms to the *Corporations Act*, Department of Treasury published an options paper to consider the appropriateness of the distinctions between wholesale and retail investors, and potential options for reform and the subsequent advantages and disadvantages of those options. The options paper invited submissions with open-ended questions for further discussion, with options ranging from retaining and updating the existing system, removing the distinction between wholesale and retail clients, introducing a financial literacy test as the sole way to distinguish between wholesale and retail investors, to leaving the current system as is.

5 Stockbrokers Association of Australia (2011), *Wholesale and Retail Clients – Options Paper, Submission to Treasury*, available at https://treasury.gov.au/sites/default/files/2020-01/stockbrokers_association_of_australia.pdf

6 Department of Treasury (2011), *Wholesale and Retail Clients - Future of Financial Advice, available at https://treasury.gov.au/consultation/wholesale-and-retail-clients-options-paper*

Quality of Advice Review (2022)[7]

The Department of Treasury published the Quality of Advice Review on how regulatory reforms can improve access to quality advice. The Quality of Advice Review identified the risks associated with being classified as a wholesale investor based on income or wealth as they are not required to be told about or to agree to the consequences of being treated as a wholesale client.

The Quality of Advice Review recommend reforming the requirements of the wholesale investor regime to require investors who meet the individual wealth thresholds and who hold an accountant's certificate to provide written consent to being treated as a wholesale investor. The recommendation aims to ensure that investors who meet the assets and income threshold are aware of and agree to the protections lost as a result of no longer being a retail investor.

Sophisticated Investor Projections – Australian National University (ANU), Centre for Social Research & Methods (2021)[8]

Associate Professor Ben Phillips at the ANU published a research note to quantify the historic and future share of Australians who could be classified as wholesale investors through satisfying the individual wealth test. Findings show that the share of households who satisfied the threshold rose from 1.4 per cent in 2002, when the legislation was first introduced, to an estimated 11.3 per cent in 2021 and is projected to rise to 49 per cent by 2041 if thresholds remain unchanged.[9] The paper raised concerns regarding the increasing number of investors being shifted into the wholesale class, and the potential implications for ways that advisers and institutions may potentially organise themselves to exploit these changes, as well as the wider integrity of the Australian financial system.

1.6 Need for reform

The primary motivation for introducing the distinction between retail and wholesale investors in 2001 was to ensure regulatory protection for retail investors and to allow certain individuals to participate in more complex wholesale products if they have the expertise and capacity to do so.[10] The individual wealth test and product value test were included as part of the wholesale investor test to determine if individuals had the means, or financial capacity, to enter into complex investments. However, these individuals have varying degrees of financial literacy and they may not be equipped to understand the consequences of riskier investments. The Household, Income and Labour Dynamics in Australia (HILDA) survey (see Box 1) shows that households in the top quintile by wealth generally have a higher degree of financial literacy,[11] suggesting that using wealth as a proxy of financial literacy is appropriate for most cases. However, there are instances when this may not be suitable, such as individuals who acquire a significant amount of money through inheritance or the sale of their home or accessing superannuation. While they may have the means to make large investments in the wholesale market, they may not necessarily have the experience or expertise to understand the risks.

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[7] Department of Treasury (2022), *Quality of Advice Review, available at https://treasury.gov.au/sites/default/files/2023-01/p2023-358632.pdf*

[8] Australian National University – Centre for Social Research & Methods (2021), *Research Note: Sophisticated Investor Projections,* available at https://csrm.cass.anu.edu.au/sites/default/files/docs/2021/10/Research_Note_Sophisticated_Investor.pdf

[9] Ibid.

[10] Treasury (2011), Wholesale and Retail Clients – Options Paper, available at https://treasury.gov.au/consultation/wholesale-and-retail-clients-options-paper

[11] Melbourne Institute (2022), The Household, Income and Labour Dynamics in Australia Survey: Selected Findings, available at https://melbourneinstitute.unimelb.edu.au/__data/assets/pdf_file/0011/4382057/HILDA_Statistical_Report_2022.pdf

Box 1 The HILDA Survey

The Department of Social Services (DSS) funds the Household, Income and Labour Dynamics in Australia (HILDA) Survey as part of research and policy development to support the lifetime wellbeing of individuals, families and communities. HILDA is a household-based panel study that collects information including:

- household and family relationships
- income
- employment
- health and education.

The HILDA Survey follows the lives of more than 17,000 Australians each year. It aims to tell the stories of the same group of Australians over the course of their lives.

Started in 2001, the HILDA Survey provides policy-makers with unique insights about Australia, enabling them to make informed decisions across a range of policy areas, including health, education and social services.

It is important to note the distinction between an individual who is classified as a wholesale investor under the sophisticated investor test versus the individual wealth test. A sophisticated investor must be someone the AFS licensee is satisfied on reasonable grounds is in fact ‘sophisticated’ and has the relevant experience to understand the risks of wholesale investments. The individual must agree to be treated as a wholesale client and in so doing they must acknowledge the protections they are giving up. In contrast, a client is classified under the individual wealth test almost by default. While the individual must be certified by an accountant to establish that they have the assets or income to meet the threshold, the certification relies on a question of fact.

There is no requirement for the client to understand the consequences of being a wholesale investor. The risk associated with using the individual wealth test is further compounded by the fact that thresholds have not been updated since 2001. Given the significant increase in asset values such as houses and superannuation over the last 20 years, it can be argued that the number of people who could potentially qualify as wholesale investors and lose the protections of the being retail investors has grown beyond the initial policy intent.

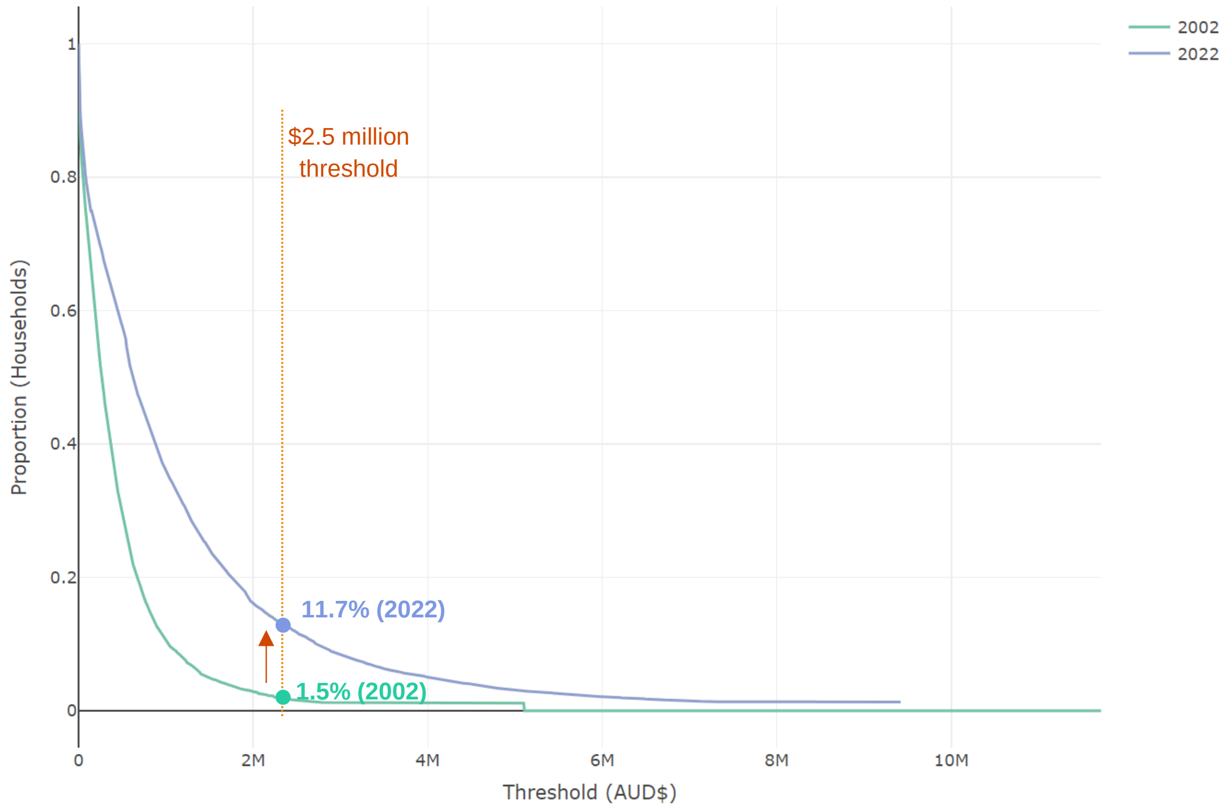
In order to understand the extent of changes, Data Analysis Australia (DAA) has drawn insights from the 2002 and 2018 HILDA survey to identify changes in the population coverage under each threshold. Findings of the HILDA survey provides an estimate of the potential pool of wholesale investors rather than actual numbers of wholesale investors. The actual number of wholesale investors will be much lower as not all those who can qualify will choose to invest. This approach is in line with the ANU research (see Section 1.4) undertaken, however the data has been used to estimate the population coverage as at 2022, allowing for a more current view.[12] DAA has used the 2018 HILDA survey to extrapolate estimates in 2022 dollar value terms to understand the current wealth and income distributions. The analysis in this section considers how the population coverage has changed between the 2002 HILDA survey and the 2022 estimates. A more detailed overview of the methodology used by DAA is included in Appendix A.

[12] The most recent data is from the 2018 survey with the 2022 data expected to be released in 2024.

Individual wealth test

Figure 1 illustrates how the proportion of households that meet the net assets test has changed between the 2002 HILDA survey and the 2022 estimates. As per the findings of the 2002 HILDA survey, only 1.5 per cent of Australian households would have qualified under the net assets threshold of $2.5 million.[13] This proportion has grown significantly, with 11.7 per cent of Australian households meeting this threshold in 2022. This means that the number of households that could qualify under the current test has grown from 104,000 to 1,085,000 which is a nine-fold increase. If the net assets threshold remains unchanged, it is estimated that by 2033, 19.1 per cent of households will have at least one person who will qualify as a wholesale investor and by 2043, this coverage will increase to 25.5 per cent.[14] If the net assets threshold is indexed by CPI, the threshold value in 2023 would be $4.3 million with a population coverage of 5.2 per cent. Further detail on indexation of the individual wealth test is included in Section 3.2. Given the significant increase over the last 20 years, and the projected increase in the future, there is a risk that the number of people who could qualify as wholesale investors and lose the protections of the being retail investors has grown beyond the initial policy intent. In the options set out in Chapter 3, the FSC therefore recommends changes to the net assets test.

Figure 1: Change in coverage of population under the net assets test



Note: DAA has included all household non-financial assets and financial assets (including superannuation) with all household debt subtracted to understand population coverage under the net assets test.

Source: DAA analysis based on 2002 and 2018 HILDA data

13 Analysis based on 2002 HILDA data.

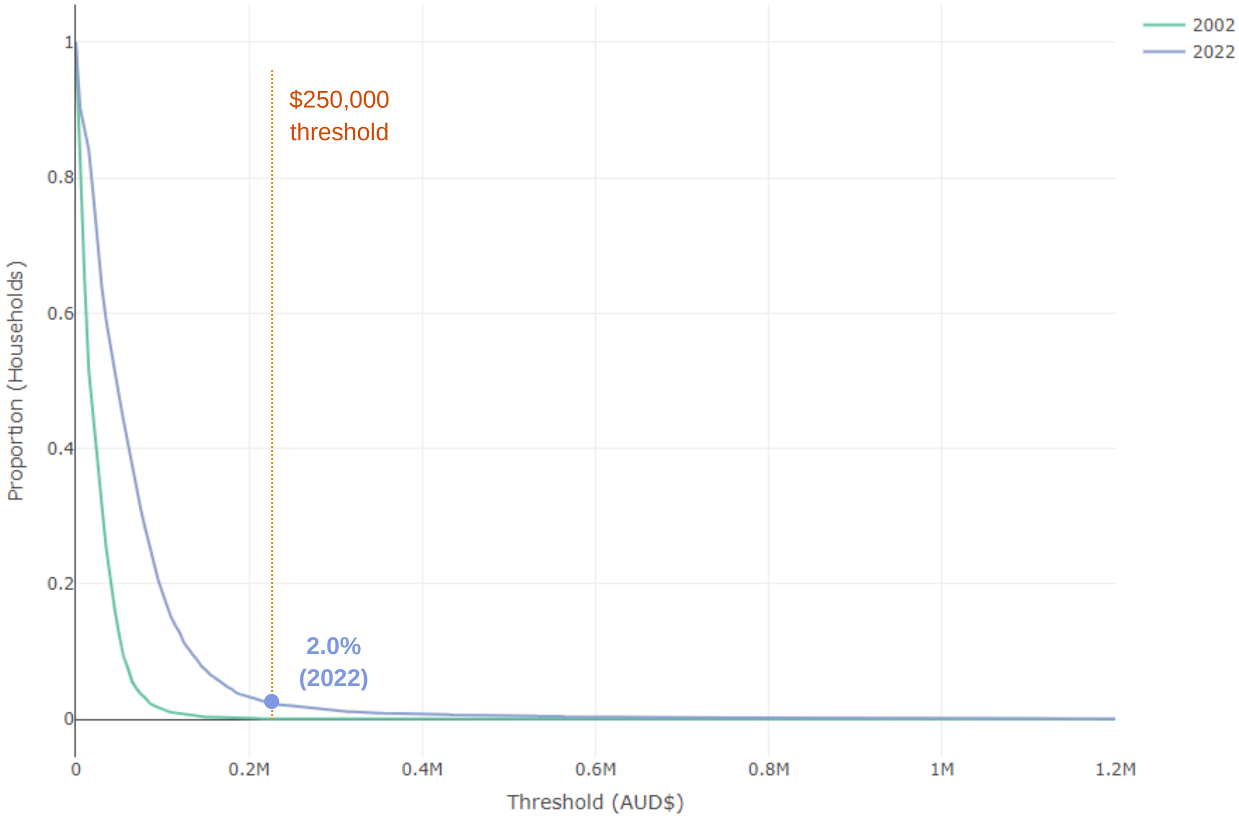
14 Analysis based on 2018 HILDA data.

Gross income test

Findings from HILDA surveys over time also provide insight into the population coverage under the gross income test. As shown in Figure 2, the proportion of Australians over the age of 15 who would have met the gross income test in 2002 was less than 1 per cent. It is estimated that in 2022, just over 2.0 per cent of Australians over the age of 15 meet the test. Indexing the gross income threshold by CPI to be in 2023 terms equates to $460,000. The population coverage at this threshold is less than one per cent and therefore, has not been included in the chart.

As the threshold remains well above the highest marginal bracket for individual income tax in 2023[15][16] and the proportion of Australians covered remains minimal, the FSC (in the options set out in Chapter 3) has not recommended any changes to the gross income test.

Figure 2: Change in coverage of population under the gross income test



Note:

1. DAA has included financial gross income with any lump sum payments (without workers compensation or insurance payouts) to understand population coverage under the gross income test.

Source: DAA analysis based on 2002 and 2018 HILDA data

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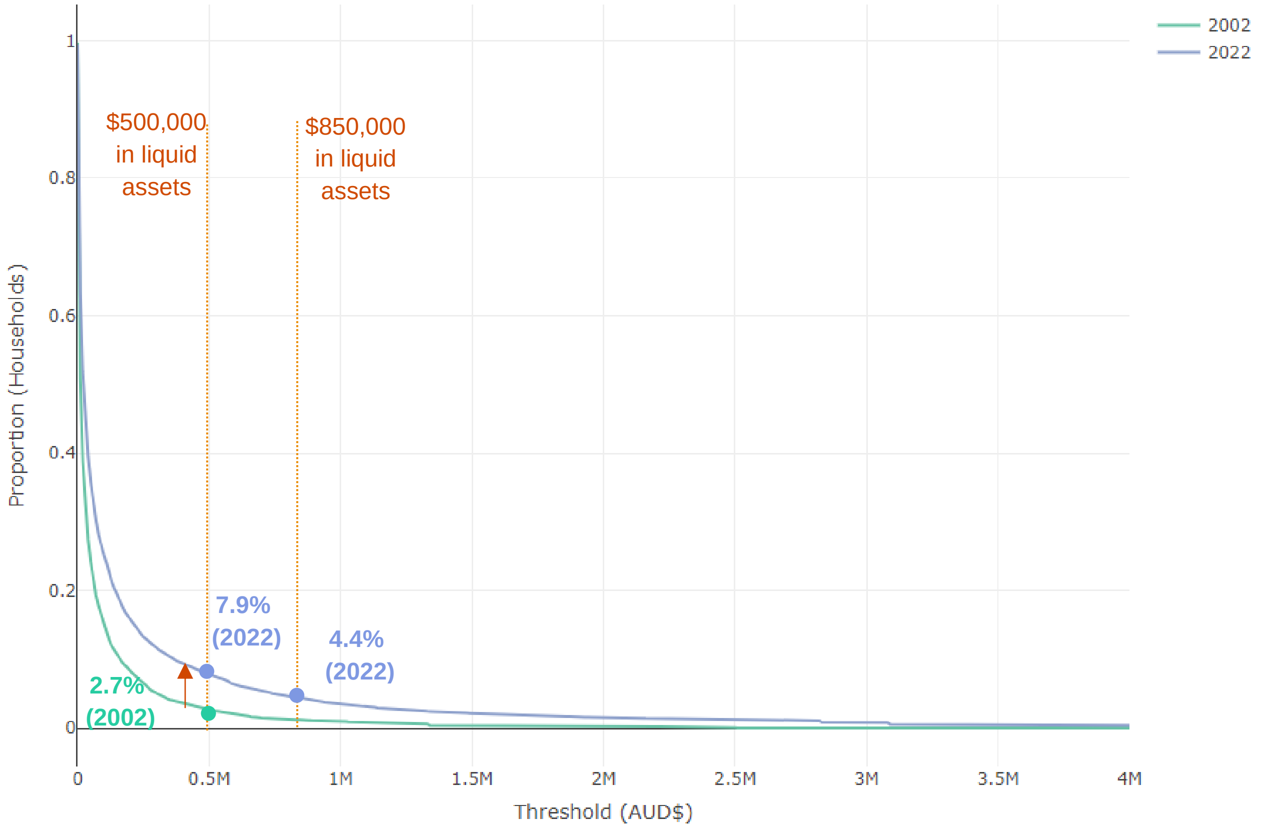
[15] ATO (2023), Tax rates – Australian resident, available here: https://www.ato.gov.au/tax-rates-and-codes/tax-rates-australian-residents#ato-Australianresidentstaxrates2020to2024

[16] Note that even with the Stage 3 tax cuts which are projected to come into effect on 1 July 2024, the gross income threshold will remain above the highest marginal bracket for individual income tax. https://www.smh.com.au/politics/federal/stage-3-tax-cuts-are-no-big-deal-with-one-exception-20231206-p5epep.html

Product value test

HILDA data on liquid assets provides a proxy for an investor's ability to meet the product value test. The proportion of households have access to more than $500,000 of liquid assets, and therefore the ability to meet the product value test, was around 2.7 per cent as per the 2002 HILDA survey. This proportion is estimated to have increased to be about 7.9 per cent in 2022. The threshold for the product value test indexed by CPI to 2023 terms equates to $850,000. The estimated coverage under this threshold is 4.4 per cent. While this is a significant increase in population coverage under the product value test, it is important to note that individuals are not likely to invest all their capital in a single investment. Given this, the FSC (in the options set out in Chapter 3) has not recommended any changes to the product value test.

Figure 3: Change in coverage of population under the product value test



Note: DAA has included all household financial assets (without superannuation) to understand the coverage under the product value test.

Source: DAA analysis based on 2002 and 2018 HILDA data

Given the significance of the population coverage and the potential risks associated with the net assets test, the analysis in this report is largely based on potential reform to the net assets threshold.

2 Approach to analysis

The analysis included in this report is based on a combination of data collection and qualitative research to understand the potential impacts of reforms to the wholesale investor test. The research and survey findings have been used to assess the costs and benefits of potential options for reform to the wholesale investor test and identify the option that is likely to deliver the best outcome for stakeholders.

2.1 Literature review

A review of wholesale investor arrangements in other jurisdictions was undertaken to consider alternative mechanisms and policies regarding complex financial products and associated wholesale investor tests. This research focussed on other developed economies and included the United States (US), Canada, the United Kingdom (UK), the European Union (EU), Hong Kong, and Singapore. Further information regarding the policies of these jurisdictions is detailed in Appendix B.

In undertaking the desktop research we also considered information in relation to population, income and education levels, and other indicators identified as potentially relevant to understanding investor behaviour. Research was also undertaken to understand the benefits of wholesale investment products and the potential impact of increased regulation and consumer protection.

Due to the limited reporting obligations, and key data constraints, there are challenges in understanding the size and number of funds, the number of wholesale investors, the nature of underlying assets, and profits across the sector. As such, the literature review was largely limited to qualitative analysis.

2.2 Survey of FSC members

A survey was issued to members of the FSC with the aim of understanding the potential costs associated with the different options being proposed. The survey asked respondents to estimate, to the best of their knowledge:

- one-off and ongoing administrative and compliance costs
- the time taken to implement required changes
- the potential implications of not including a grandfathering provision for each of the proposed options.

The survey was issued to 12 FSC members, with 10 responses received. The findings of the survey were used to inform our judgements regarding the potential implications of reform, namely through understanding the additional financial costs imposed on financial managers and advisors.

2.3 Cost benefit analysis

As discussed in Section 2.1, there is limited data available to understand the size of the wholesale investment market which poses challenges in quantifying potential benefits and costs of reform. In the absence of this data, a multi-criteria analysis (MCA), a form of cost benefit analysis (CBA), has been undertaken to assess the relative impacts of the proposed options.

An MCA is an appraisal tool used to value multiple options against each other using criteria with assigned weightings. Options are scored based on their performance against each weighted criterion, the sum of the weighted scores then being used to rank each option against others. An MCA can provide structure and transparency to an assessment where quantifying all costs and benefits in monetary terms is neither possible nor practical in an efficient and timely manner.[17]

[17] TPG23-08 NSW Government Guide to Cost-Benefit Analysis, NSW Treasury, February 2023

Box 2 Data needed for a full CBA

A CBA would include quantifying costs and benefits of each proposed option incremental to the current test arrangement, or the base case. Developing a full CBA that calculates a benefit cost ratio (BCR) for each option requires a set of parameters and assumptions. While the survey of FSC members provides some inputs on the expected costs, data is needed for the following:

- losses incurred in wholesale investment products versus retail investment products
- the probability of incurring losses in wholesale investment product versus retail investment products
- the size of the wholesale investment market (e.g. count of businesses and total funds under management)
- cost to government under each option being considered.

In addition, assumptions will need to be made about certain investor behaviours. Prospective wholesale investors who no longer qualify post-reform are likely to switch to one of few options. Assumptions will need to be made regarding the proportion:

- switch to the retail investment products
- switch to other non-regulated investment products
- that would no longer invest their money.

While some of this information is available, not all information is. In the absence of this full set of data and assumptions to quantify costs and benefits, it is challenging to deliver a complete CBA.

3 Options

3.1 Overview of international comparison

The requirements for wholesale investor equivalents in other developed economies include a combination of thresholds on wealth and income to identify financial capacity, and qualitative assessments of relevant knowledge, experience and professional accreditation to recognise financial expertise. A summary of requirements for select international jurisdictions is included in Appendix B.

The need for reform that ensures wholesale investor tests (and their equivalent) are up to date in the present economic conditions is evident in other jurisdictions too. In November 2023, the HM Treasury published a consultation response on changes to the scope of the financial promotion exemptions for certified high net worth individuals, which confirmed changes will be made to the thresholds for exemptions to financial promotion.[18] The reform will change the thresholds to:

- income of at least £170,000 (AUD$310,000) in the last financial year, or
- net assets of at least £430,000 (AUD$780,000) throughout the last financial year.

Considerations in determining wholesale investors

Across all jurisdictions considered, requirements to qualify as a wholesale investor (or equivalent) broadly fall under three categories:

- **Financial literacy** which considers the individual's ability to assess the risks and benefits of investments based on experience, expertise, or accreditations. The current wholesale investor test in Australia includes assessments on financial literacy through the sophisticated investor test.
- **Financial capacity** which considers the individual's wealth and income as a proxy for being able to enter large investments. As summarised in Appendix B, the thresholds for wealth and income vary in magnitude and definitions. The individual wealth test in Australia considers financial capacity by implementing thresholds on wealth and income.
- **Consent requirements** which entail acknowledgment by the individual that they understand the risks associated with investing in wholesale investments. This requirement is currently implemented in the EU and UK. Currently, there are no consent requirements under the wholesale investor test in Australia.

There is an opportunity to consider the mechanisms and reforms being implemented in other jurisdictions when defining options for reform to the wholesale investor test in Australia.

3.2 Options definition

A number of policy options were developed by the FSC to consider reform to the wholesale investor test. These options are targeted at improving assessments for financial capacity.

Option 1: FSC Proposal

The FSC proposal includes changes to:

- Individual wealth test, including:
  - Net Asset Test: Increase the requirement for net assets from $2.5 million to
    - $5 million including the family home OR

[18] HM Treasury (2023), Financial promotion exemptions for high net worth individuals and sophisticated investors: Consultation response, available at https://assets.publishing.service.gov.uk/media/65491981bdb7ef000d4af915/Consultation_response_document_-_updates_to_financial_promotion_exemptions.pdf

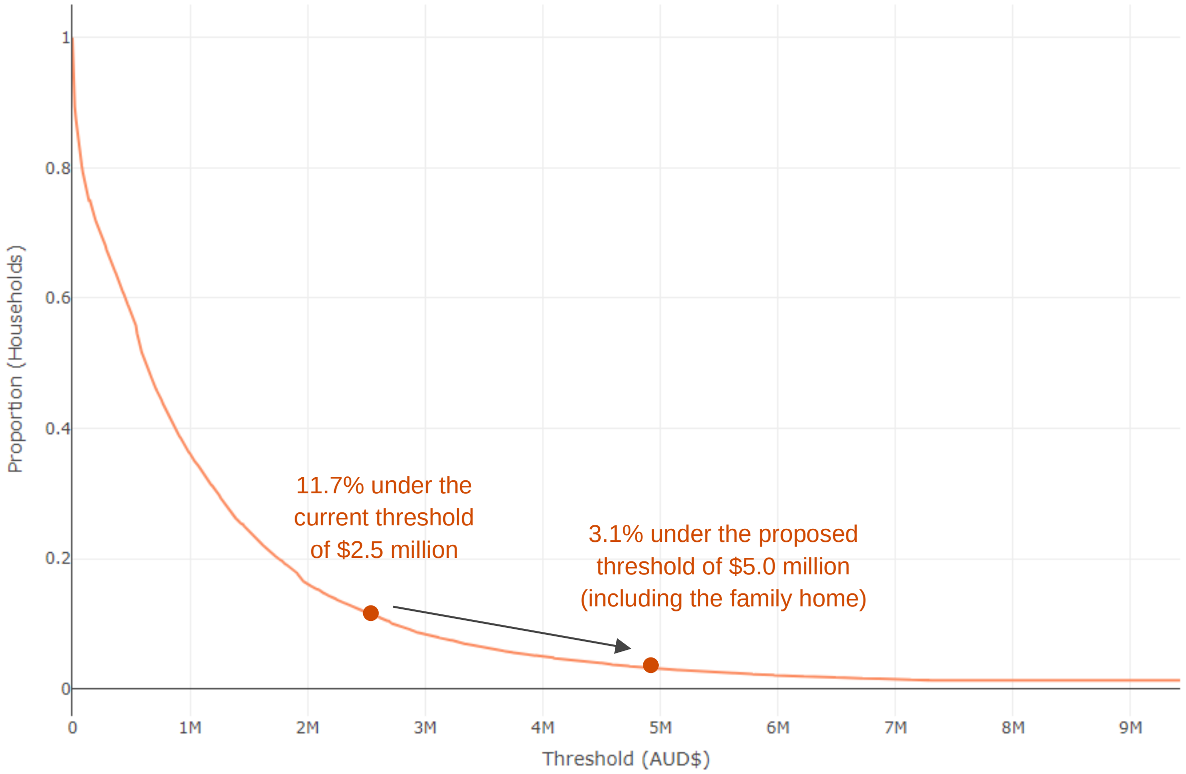
    - reduce to $2.4 million excluding the family home.
  - Gross Income Test: Maintain the current requirement for gross income to be $250,000 in the last two financial years.
- Product Value Test: Maintain the current $500,000 threshold.
- Sophisticated Investor Test: The FSC proposes to address the high degree of subjectivity in this test by including a safe harbour that outlines the steps AFS license holders need to be satisfied of on reasonable grounds.

FSC's rationale for this option

The FSC proposal option aims to further improve the assessment of financial literacy under the sophisticated investor test and maintains the current gross income threshold as this is still well above highest marginal tax rate.

The FSC proposal aims to improve assessment of financial capacity by increasing the threshold for the individual wealth test and considers a change to the threshold excluding the family home. As shown in Figure 4, under the proposed changes to the net assets test which includes the family home, 3.1 per cent of the Australian households would meet the wholesale investor test based on wealth, which is a significant reduction compared to the coverage under the current regime.

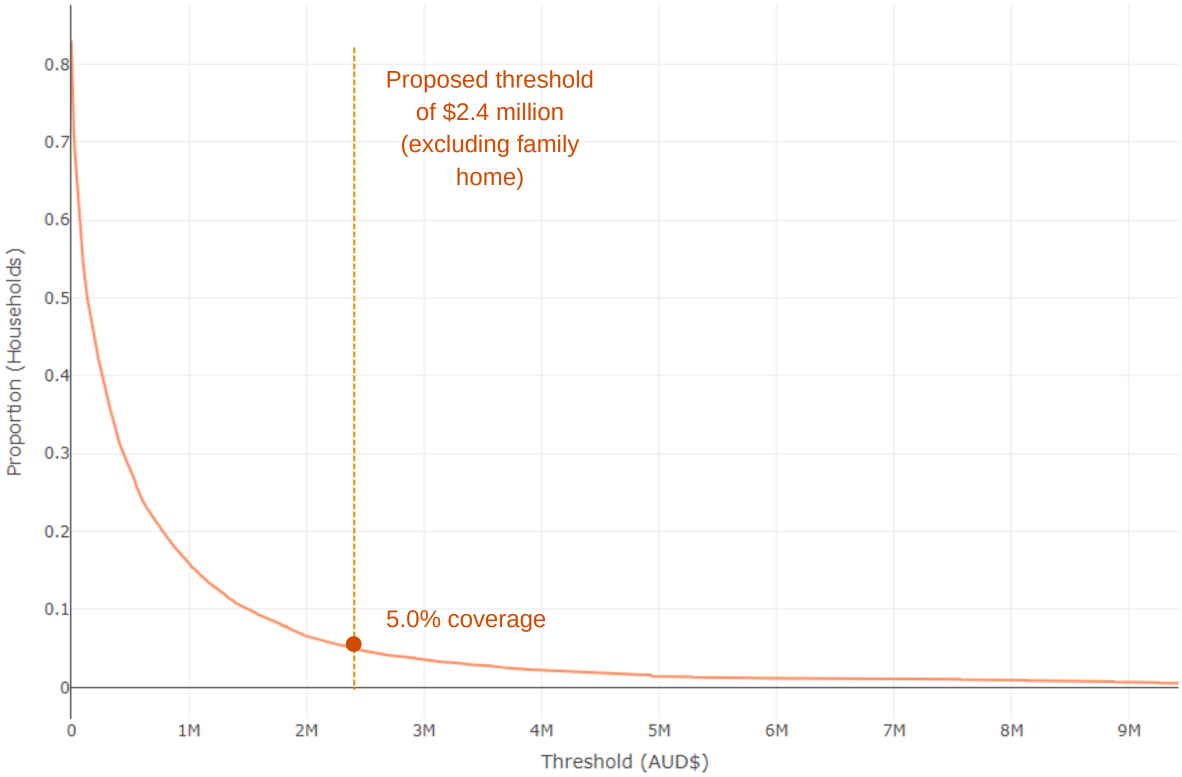
Figure 4: Expected change in coverage of population under FSC proposed option (including the family home)



Source: Analysis based on 2018 HILDA data

Alternatively, if the threshold was changed to $2.4 million excluding the family home, the coverage of population would reduce to 5 per cent.

Figure 5: Expected coverage of households under FSC proposed option (excluding the family home)



Source: Analysis based on 2018 HILDA data

Option 2: Indexation approach

Under this approach, the values of the wealth test for net assets and gross income will be indexed annually in line with inflation.

FSC's rationale for this option

The indexation approach aims to better assess financial capacity by indexing the thresholds in line with inflation. This option would ensure that the individual wealth tests will remain relevant in the future and will decrease the need for periodic reviews.

Under this option, the threshold of $2.5 million set in 2001 has been adjusted to 2023 terms. While it is challenging to determine the actual thresholds in the future as they rely on CPI, using RBA's forecasts for inflation, estimated changes to the threshold have then been calculated over the next 10 years as shown in Table 1.

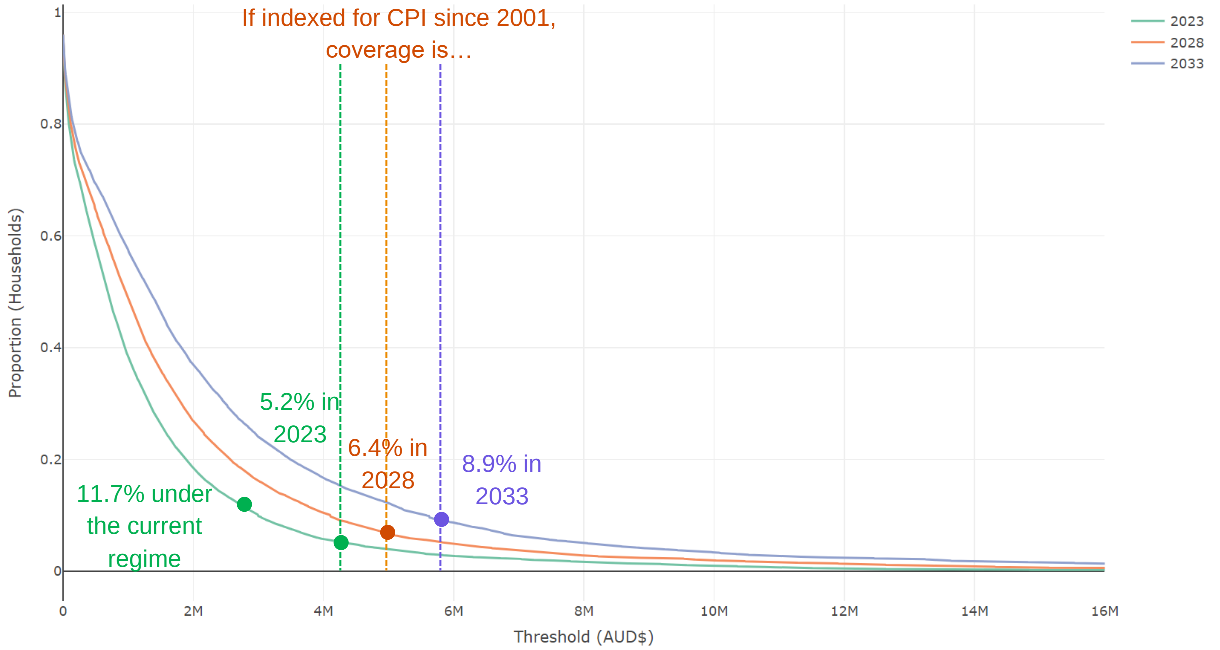
Table 1: Estimated threshold changes under Option 2 over the next 10 years

	2023	2024	2025	2026	2027	2028	2029	2030	2031	2032	2033
Estimated threshold for net assets (including the family home, $m)	4.3	4.6	4.7	4.9	5.0	5.1	5.3	5.4	5.6	5.7	5.9

Source: Estimated using CPI forecasts in RBA (2023) *Statement on Monetary Policy August 2023*

While this option would index the threshold annually by the CPI, since asset prices tend to increase above CPI, the proportion of the population that would meet the test will still increase over time under this option. In order to estimate what the future eligible population share is, growth in wealth has also been projected over the next 10 years using a combination of long run growth in property prices,[19] financial assets[20] and other non-financial assets.[21] Figure 6 shows the estimated coverage under the projected threshold changes, which is expected to reduce from 11.7 per cent under the existing regime to 5.2 per cent in 2023 if indexed. The coverage is projected to increase to 6.4 per cent in 2028 and 8.9 per cent by 2033 as the threshold is indexed to inflation.

Figure 6: Expected coverage of households under the indexation approach (including the family home)



Source: Analysis based on 2018 HILDA data

Option 3: Re-assessment approach

Under this approach, a statutory requirement will be set that the Minister consults with the public every few years about the threshold values (every three to five years). This option assumes no pre-determined increase or indexation.

FSC's rationale for this option

The re-assessment approach allows a periodic review of the thresholds to ensure that they remain relevant in the future. It is challenging to estimate changes in the coverage of population under this option as it requires wider consultation by the Minister, however, any future changes to thresholds under this option is likely to result in fewer wholesale investors.

Grandfathering provisions

The FSC assumes that under all the options considered, a two-year transition period and grandfathering provisions should be included. Grandfathered wholesale investors should be able to re-invest distributions back into the fund and make further investments without having to be re-assessed. They should be considered a wholesale client in respect of all financial services associated with a product that was issued to them at a time when they qualified as a wholesale client. The central analysis in this report assumes that grandfathering will be included, however, sensitivity analysis to understand the relative impact in the absence of such provisions is also included in the report.

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19 Property price growth has been projected using the 30-year average growth in the ABS property price index.

20 Growth in financial assets has been projected using the 30-year average growth in Australian bonds, available here: https://aemdam.assets.vgdynamic.info/assets/intl/australia/fas/documents/resources/A1_2023_Index_Chart_poster.pdf

21 Growth in non-financial assets has been projected using RBA CPI forecasts.

4 Analysis

The proposed options for reform will have a significant impact on a range of stakeholders:

- Fund managers and financial advisors will need to adopt changes to the regulatory framework and governance requirements, which are likely to entail financial costs and a greater compliance burden.
- Individual investors are also likely to be impacted by the reforms as:
  - up to 1.1 million individuals will no longer qualify based on wealth alone[22]
  - a subset of these individuals will move to the retail investment market which provides greater consumer protection and economic certainty
  - the reforms will also have an impact on the ability to access potentially higher returns through wholesale investment markets, as well as limiting choice in investment options
  - while existing wholesale investors are not expected to be impacted due to grandfathering provisions and a two-year transition period, prospective wholesale investor clients who no longer qualify will be forced to move to alternative investment markets.

A detailed analysis of the impact of the proposed reforms has been included below.

4.1 Implications for consumers

Increased consumer protection

Currently, wholesale investors are not offered the same degree of protection as retail clients due to limited governance and compliance provisions. Under the proposed options, the pool of individuals who qualify as wholesale investors will decrease, and it is likely that a proportion of those investors will move to the retail market, providing them with greater economic and financial protection.

Proponents of the wholesale investor industry argue that sophisticated investors can presumably ensure the degree of protection they require due to their experience, expertise and capacity, and therefore do not require generalised government protection that may exist for small consumers who do not have the same resources.[23] However, given that the proportion of households that could qualify under the current test has grown from 1.5 per cent to 11.7 per cent, (see Section 1.6) there is a risk that not all these individuals possess the ability to sufficiently protect themselves. The HILDA survey indicates widespread financial illiteracy in Australia, with 45 per cent of the population not understanding basic financial literacy concepts (i.e. classified as financially illiterate).[24]

Investment schemes that are offered to retail clients generally provide greater protection due to the following requirements:

- Retail investors receive all the consumer protections introduced in the FOFA reforms, including a best interests duty obliging advisors to place the interest of their clients ahead of theirs when providing advice to retail clients was introduced.[25] These protections generally do not apply to wholesale investors.

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[22] Based on analysis of HILDA data.

[23] Garten, H.A. (1999), The Consumerization of Financial Regulation.

[24] University of Western Australia, Financial Literacy in Australia: Insights from HILDA Data, available at https://api.research-repository.uwa.edu.au/ws/portalfiles/portal/73668586/Financial_Literacy_in_Australia.pdf

[25] ASIC, Future of Financial Advice (FOFA) reforms, available at https://asic.gov.au/regulatory-resources/financial-services/regulatory-reforms/future-of-financial-advice-fofa-reforms/

- The Corporations Act sets out ongoing disclosure obligations for advisors when dealing with retail clients and has more prescriptive requirements around providing advice that meets the clients' individual circumstances. Wholesale investors can choose to receive an Information Memorandum, which are not as regulated.
- Retail investor funds are required to meet increased governance requirements set out by ASIC, such as an approved constitution and compliance plan, and a mandated net tangible assets requirement. Wholesale investor funds may be able to vary these requirements as part of the fund deed.

These provisions ensure transparency and disclosure of relevant information to retail clients when advising them on their investments, providing a higher degree of consumer protection for individual investors.

Improved ability to seek recourse

Wholesale clients do not have the same ability as retail clients to seek recourse in the event of losses due to misconduct. The Australian Financial Complaints Authority (AFCA) has a clear mandate for the complaints it can hear from retail clients for dispute resolution. AFCA's jurisdiction over wholesale clients is more discretionary. AFCA indicates that it is likely to hear complaints where a retail client has been incorrectly classified as a wholesale client. Moreover, AFCA is limited to a cap of $500,000 per claim which would mean some wholesale clients will be outside its jurisdiction due to the nature of wholesale investment amounts.[26]

Under the proposed options, an increased number of investors will benefit from recourse options provided for retail clients. Depending on the option that is implemented, up to 1.1 million additional individuals would qualify for greater protection and options for recourse that are available to retail investors.

Greater degree of economic certainty

Wholesale investments typically have a riskier profile and at times, can lead to significant losses and greater economic uncertainty for individuals. Wholesale investment opportunities often also contain an in-built 'illiquidity premium', which makes it hard to get out of schemes until maturity.[27] This risk is particularly pronounced for individuals who qualify under the individual wealth test where no assessment is made on financial literacy or expertise. There is an opportunity to address this risk by increasing the threshold to reduce the number of people who qualify based on wealth alone.

There have been multiple instances of every day Australians incurring significant losses where they were involved in wholesale investments without fully understanding the consequences. For instance, Mayfair 101 was an investment fund that was found to have published misleading and deceptive advertising marketed to wholesale but inexperienced investors, a subset of whom were unlikely to understand the significant risk associated.[28] Mayfair implemented a redemption freeze, preventing investors from pulling their money out. ASIC investigations found that more than 500 people invested in the group and were owed more than $200 million as of 2022.[29] This included individuals who had qualified for Mayfair's products under the individual wealth test or product value test, with limited assessment of their financial literacy and awareness around consequences such as a redemption freeze.[30]

The risk of providing general, 'one size fits all' financial advice and the lack of financial literacy was also evident in the collapse of Storm Financial. The *Inquiry into Financial Products and Services in Australia* (the Inquiry) noted that failure to better inform consumers about the products they are investing in with consideration for their individual circumstances

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[26] AFCA, *The AFCA Approach to calculating loss in financial advice complaint,* available at https://www.afca.org.au/sites/default/files/2019-12/factsheet-afca-at-a-glance.pdf

[27] AFR (2021), *Why being 'sophisticated' isn't always smart for investors,* available at https://www.afr.com/wealth/personal-finance/why-being-sophisticated-isn-t-always-smart-for-investors-20211013-p58zma

[28] Federal Court of Australia (2022), Mayfair Wealth Partners Pty Ltd v Australian Securities and Investments Commission [2022] FCAFC 170, available at https://download.asic.gov.au/media/2phjwlr1/22-273mr-mayfair-v-asic-judgment.pdf

[29] ASIC, ASIC Investigation into Mayfair, available at https://asic.gov.au/about-asic/news-centre/key-matters/asic-investigation-into-mayfair-101/

[30] AFR (2021), Widower's Mayfair woe spotlights 'wholesale investor' tag, available at https://www.afr.com/companies/financial-services/widower-s-mayfair-woe-puts-focus-on-wholesale-investor-tag-20210215-p572jm

resulted in investors falling into negative equity and were sold out of their portfolios in 2008 at the onset of the Global Financial Crisis (GFC). The Inquiry received over 200 submissions from investors who incurred significant losses, including retired and elderly individuals, some of whom were forced to seek employment at the peak of the GFC.[31]

Such events demonstrate that often investors lack the expertise to filter poor financial decisions in the absence of sound financial advice and information. Reducing the volume of investors who access the wholesale investment market purely based on wealth has the potential to benefit investors by reducing the risk of significant losses.

Lower returns and reduced diversification

Wholesale investors can access a wider and more complex range of investment products, which therefore offers greater opportunities for diversification. Wholesale investment funds typically have lower costs and management fees than retail funds due to reduced compliance and governance requirements. Although the risk profile of wholesale investments is greater than retail investments, they also present the opportunity to realise higher returns. Additionally, wholesale investment opportunities provide access to a wider range of financial advice firms that specialise in wholesale only business models.

The proposed options for reform will reduce the number of people who can access these wholesale investments. This means that compared to the current test arrangements, more individuals will be locked out of lucrative investment opportunities which can have a long-term impact on wealth creation. Impeded access to opportunities to grow wealth is important to note when considering wealth inequality in Australia, which in turn, has an impact on general community wellbeing. Data published by the Treasury shows that the level of wealth inequality in Australia is almost double that of income inequality. [32]

While increasing the threshold for the individual wealth test increases consumer protection, it also locks out a significant proportion of the population from wholesale investment opportunities. For example, under Option 1, only 5 per cent of the population will be able to access the opportunities in the wholesale investment market.

Increased risk associated with alternative investment options

Reform to the wholesale investor test will likely result in a shift in the investment patterns of prospective investors who will no longer qualify under the individual wealth test. While some will seek opportunities to invest in the retail market, others may choose to invest in alternative investment products that present the possibility of making greater returns. It is crucial that any reforms that are introduced consider the outcomes of individuals moving to riskier products (e.g cryptocurrency or investing their money in overseas markets, which may not be as highly regulated as the Australian market).

Literature on the role of regulation highlights that at times, regulatory measures can have untended consequences.[33] The introduction of stringent regulatory controls can result in opposition from the industry and a general reluctance to abide by arduous controls. Similarly, well intended steps to increase disclosure requirements can be self-defeating if there is an information overload, causing consumers to treat a large amount of information as equivalent to no information at all.[34] There is a risk that individuals who are forced out of the wholesale investment market because of the reform find the level of governance and compliance in the retail market too onerous, and instead they seek opportunities in riskier products such as cryptocurrency. Investing in cryptocurrency presents the potential to make greater returns without the regulatory requirements of the retail investment market. However, crypto is a highly volatile and risky market, and there is not yet a consistent approach to regulating cryptocurrency activities. There is an elevated risk of fraudulent activities and scams occurring in the cryptocurrency market. Alternatively, individuals may seek opportunities for investment in overseas markets with the prospect of realising higher rewards. However, investments in overseas markets are not covered by Australian

[31] Parliamentary Joint Committee on Corporations and Financial Services (2009), Inquiry into financial products and services in Australia, available at https://www.aph.gov.au/~/media/wopapub/senate/committee/corporations_ctte/completed_inquiries/2008_10/fps/report/report_pdf.ashx

[32] Treasury (2023), Income and Wealth Inequality, available at https://treasury.gov.au/policy-topics/measuring-what-matters/dashboard/income-wealth-inequality

[33] Sunstein, C.R. (1990), *Paradoxes of the Regulatory State.*

[34] Ibid.

regulations, and as such, individuals take on a greater degree of risk as there are limited options for recourse if losses occur as a result of misconduct. It is crucial to take a balanced and complete view of the potential impacts when assessing the proposed options for reform.

4.2 Implications for fund managers, financial advisors and accountants

Transition costs associated with reform

Fund managers, financial advisors and accountants are likely to experience transition costs in the form of administrative costs, the time taken to implement the changes, changes to systems and training of employees. The impact of any change is likely to vary depending on the current set up of the business. For instance, funds and advisors that only operate using the professional investor test will experience minimal to no impact under all the proposed options as they are limited to the individual wealth test or the sophisticated investor test. Costs are likely to be higher for those who are specialised in wholesale investment products compared to those who cater to both wholesale and retail clients. It is unlikely that the reform would be a straightforward pivot as it would require significant retraining and accreditation to meet the compliance and governance standards of the retail investment industry.

The impact on stakeholders in the industry are summarised below:

- Qualified accountants are required to issue certificates stating that a prospective wholesale investor meets the thresholds set out in the individual wealth test. If the thresholds are changed, accountants will incur costs in implementing the threshold changes.
- Financial advisors and AFS license holders will also incur one-off costs in implementing the reforms to thresholds.
- Fund managers will be impacted by one-off costs associated with the reform. The survey of FSC members provided insights on the likely transition costs, which are included below:
  - Under all the proposed options, the time taken to implement the changes could take more than a year.
  - There are likely to be one-off costs in seeking legal advice for updating forms, issuing communications and re-training staff. These costs are expected to be relatively higher where periodic reviews and changes are needed, for example, under Option 2 and Option 3.
  - As part of the survey, respondents were asked to provide a best guess estimate of the financial costs associated with the reform options. Members indicated that the cost under all options would be broadly similar, even though Option 2 and Option 3 may entail changes every time the threshold is changed. Table 2 presents a range for these costs per business based on survey responses.
  - Notably, most respondents indicated that not including a grandfathering provision would substantially increase transition costs and complexity as it would lead to a greater loss of existing wholesale clients and would require additional communications and re-assessment of whether existing clients qualify. Survey responses indicated that costs could be more than $250,000 per business depending on the detail of how the reform is implemented.

Table 2: One-off costs for fund managers associated with the proposed options, per business

	Option 1	Option 2	Option 3
One-off cost*	$10,000 - $100,000	$10,000 - $100,000	$10,000 - $100,000

Note: * The responses provided a range of expected one off costs. The figures included in the table represent the upper bound estimate of costs indicated.

Higher ongoing costs

Changes to the wholesale investor test are likely to create an additional burden of compliance for fund managers, advisors and accountants.

- Accountants will need to monitor changes to the thresholds when assessing prospective wholesale investors' net assets and gross income.
- Financial advisors will have higher compliance requirements if they have to pivot to more retail clients as a result of the changes. There is also a higher degree of operational risk of non-compliance when advising retail clients, which can result in additional costs in the event of a breach.
- Managed investment schemes that are offered to retail clients must, in most cases, be registered with ASIC. The disclosure requirements and regulations are much higher for retail investors and ASIC requires funds to meet higher governance requirements. This means that implementing reforms that lead to funds and advisors catering to more retail investors will result in higher ongoing costs. The survey indicated respondents expect higher ongoing costs associated with all the proposed options. A summary of the potential ongoing costs is included below:
  - Costs associated with greater need for recordkeeping and communication with clients if the wholesale investor test is reformed.
  - All options are likely to incur compliance costs associated with updating forms, communication with clients and potential re-training of employees.
  - Table 3 includes a range for the ongoing costs indicated by survey respondents for each option. These represent the total cost incurred over a 10-year period by a single business.
    - Survey responses suggest that ongoing administrative costs and compliance costs are likely to be highest for Option 3 followed by Option 2 as there is a higher degree of uncertainty associated with how the thresholds and requirements will change. There will be a repeated need for monitoring changes and communications associated with both options.
    - Responses to the survey suggest that some respondents interpreted Option 3 as requiring re-assessment of existing investors every three to five years when the thresholds are updated. However, Option 3 would only require the thresholds to be re-assessed periodically, with no impact on existing wholesale investors. That is, the existing threshold would be grandfathered every time the Minister reviews and updated the thresholds. As such, some survey responses indicate a higher cost for Option 3 compared to Option 2, however, the upper bound of the range is broadly similar.
    - Ongoing costs for Option 1 are lower than the other two options as they don't require periodic review or changes.
    - Survey responses indicate that costs would be much higher if current arrangements are not grandfathered. The costs would be particularly high if the funds must force redemption of funds for investors who no longer qualify. The survey indicated costs could be up to $3.8 million per annum depending on how many clients must be re-classified.

Table 3: Ongoing costs for fund managers associated with the proposed options, per business

	Option 1	**Option 2**	**Option 3**
Ongoing administrative costs	$40,500 - $81,000	$40,500 - $810,000	$162,000 - $810,000

Notes: The responses to the survey provided a range of expected ongoing costs. The figures included in the table represent the upper bound estimate of costs indicated. Outliers were not included in the analysis. The ongoing costs shown in this table are in net present value (NPV) terms, which shows the present value of the total costs expected over the next 10 years. A 5 per cent real discount rate has been applied, in line with NSW Treasury guidance on cost-benefit analysis.

4.3 Impact on capital raising

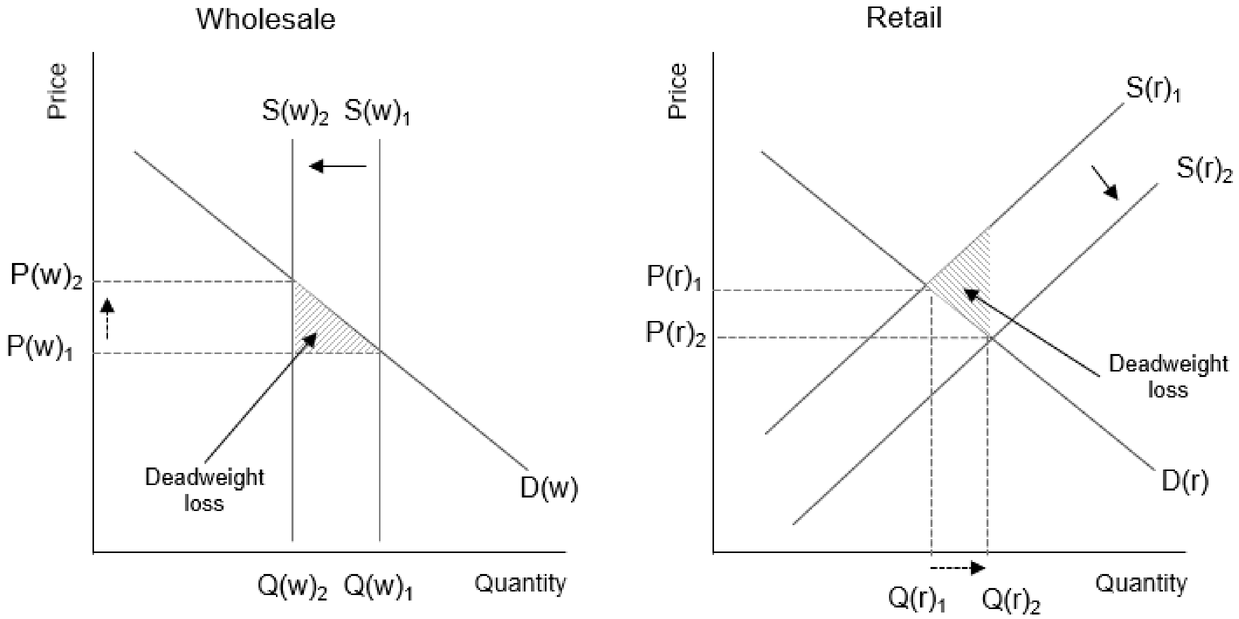
While the proposed reforms are aimed at protecting investors on the margins, it is important to consider the potential risk to capital raising when considering the reduction in the potential pool of wholesale investors. As some prospective clients will no longer qualify as wholesale investors, there will likely be an impact on the ability of companies to raise capital.

Figure 5 shows a simplified illustration of how demand and supply in the wholesale and retail investment markets might be impacted by the reform. The chart on the left shows the demand for capital raised through wholesale investments, denoted as 'D(w)', and the current supply of capital, denoted as $S(w)_1$, which is a function of the number of investors willing and qualified to invest in wholesale products.

Reforming the wholesale investor test will likely reduce the supply of funds, denoted as $S(w)_2$, as fewer investors will qualify. The impact of this change is a reduction in capital raised, shown as the movement between $Q(w)_1$ and $Q(w)_2$, and the increase in price or cost of funds, shown as the movement between $P(w)_1$ and $P(w)_2$. As demand and supply of capital raised in the wholesale markets is no longer in equilibrium,[35] there is a loss of market efficiency (known as deadweight loss), as companies are now faced with higher cost of raising capital.

It can be argued the investors will move from the wholesale market to the retail market, illustrated in the chart on the right as the movement between $S(r)_1$ and $S(r)_2$, resulting in more funds being raised ($Q(r)_1$ to $Q(r)_2$), however, the ultimate recipients of funds in the two markets are different. In its submission to the Treasury *Wholesale and Retail Clients - Options Paper,* the Stockbrokers Association of Australia highlighted the risks associated with reducing the number of wholesale investors.[36] It noted that small-cap companies, with a market cap of less than $100 million are particularly at risk as they are most likely to raise capital through placements which are typically offered to individual wholesale investors.

Figure 4: Supply and demand of capital in wholesale and retail investment markets



Source: PwC analysis

[35] The analysis for the purpose of demonstrating the impact of reform is based on a simplifying assumption that the market is in equilibrium pre-reform. In reality, this may not be the case as there are other costs that impact market equilibrium.

[36] Stockbrokers Association of Australia (2011), *Wholesale and Retail Clients – Options Paper, Submission to Treasury*, available at https://treasury.gov.au/sites/default/files/2020-01/stockbrokers_association_of_australia.pdf

4.4 Implications for government

Costs associated with reforming the wholesale investor test

Government is expected to incur one-off and ongoing compliance costs associated with the proposed reform options for the wholesale investor test. A summary of these potential costs is included below:

- There will be one-off costs incurred in relation to changing legislation to reflect the changes, updating documentation and communication with industry and the community.
- Option 3 will incur costs every time the policy is re-assessed as the Minister will be required to undertake consultations and review the requirements every three to five years.
- Option 2 will incur annual costs associated with implementing the changes associated with indexing the thresholds.
- As more investors move to retail investment products, there will be a greater degree of compliance and regulation of fund managers and advisors who previously only specialised in wholesale investments. Therefore, there are ongoing costs associated with ensuring a higher number of managers and advisors are not in breach of these requirements.
- Under the proposed options, more investors will also be able to access the dispute resolution mechanisms available to retail investors, which would result in costs to government.

4.5 Multicriteria analysis

Method of the multicriteria analysis

As detailed in Section 2.3, an MCA is a tool to compare reform proposals. A multicriteria analysis has been completed to understand the incremental impact of the proposed options. The analysis is based on a range of criteria listed in Table 5. Each criterion has been assigned a weighting which is used to determine the final score. Consumer protection accounts for the highest weighting due to the heightened risk for individuals who qualify based on wealth alone. All other criteria have been weighted equally.[37]

Table 6 shows the results of the analysis. The scores indicate the incremental impact of each option compared to the current wholesale investor test (the base case) against the set of criteria identified. The scores range from -3 to +3, where zero represents the base case, -3 represents a negative outcome compared to the base case and +3 represents a positive outcome compared to the base case. A weighted average is calculated to get an overall score for each option.[38]

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[37] The allocated weighting is based on judgment and different viewpoints may justify alternative weightings.

[38] The scoring is done on a relative basis to compare the options proposed in this report. For instance, an option may score +3 relative to another option that scores +2, however there may be reform options not considered in this report that score even higher than the former option.

Table 5: Assessment criteria and description

Criteria	Weighting	Description
Consumer protection	60%	• The scale of potential wholesale investors who will no longer qualify as wholesale investors • The provision of more transparent advice on the potential consequences of wholesale investments • The degree of responsibility that individual investors need to take to understand the consequences of their investments • The requirement for individual investors to monitor and consider changes to the wholesale investor test
Transition costs	10%	• The one-off administrative costs incurred by fund managers, accountants, and financial advisors • Costs incurred by government to review and implement the changes
Ongoing costs	10%	• The ongoing compliance and administrative burden incurred by fund managers, accountants and financial advisors • Costs to government associated with greater need for compliance and governance
Impact on capital raising	10%	• The impact on the availability and cost of funds due to fewer wholesale investors compared to the base case
Access to higher risk-adjusted returns and diversified investments	10%	• The volume of potential investors who will no longer be able to access a diversified range of wholesale investment products with higher risk-adjusted returns

Source: PwC analysis

Figure 7: Key for scoring in Table 6

Outcome	Negative outcome compared to base case			Neutral compared to base case	Positive outcome compared to base case		
Score	-3	-2	-1	0	+1	+2	+3

Key findings of the multicriteria analysis

- Based on the multicriteria analysis, Option 1 scored the highest as the potential pool of investors who receive greater consumer protection is the largest under this option. Option 1 also incurs lower costs compared to the other options as it does not require periodic reviews or changes and is less complex to implement.
- Option 2 scored lower due to the repeated need for changes associated with indexation. This is likely to result in costs for fund managers, advisors, accountants and government. Option 2 also reduces the pool of investors who can access wholesale investments compared to the current regime, providing consumer protection to more individuals, however the magnitude of the change is lower than for Option 1.
- Option 3 scored the lowest due to the high degree of uncertainty and repeated need for review. Fund managers, advisors and accountants are likely to incur costs in monitoring changes periodically. Government will also incur costs in doing consultations and implementing changes every three to five years.

Table 6: Results of the multicriteria analysis1

	Option 1	Option 2	Option 3
Consumer protection (60%)	2.5	1.5	1.5
	• Compared to the two other options, Option 1 sees the biggest reduction in individuals qualifying for riskier wholesale investment products.	• Fewer individuals qualify for wholesale investment products, however the reduction is not as much as Option 1.	• Likely to see a gradual reduction in the number of individuals who qualify for riskier wholesale investment products.
Transition costs (10%)	-1.3	-1.3	-1.7
	• One-off costs ranged from $10,000 to a maximum of $100,000 • Government likely to incur costs in implementing and communicating the change.	• One-off costs ranged from $10,000 to a maximum of $100,000 • Government likely to incur costs in implementing and communicating the change.	• One-off costs ranged from $10,000 to a maximum of $100,000, incurred every time there is a change. • Government likely to incur costs in implementing and communications every time there is a change.
Ongoing costs (10%)	-1.0	-1.7	-2.0
	• $5,000 to $10,000 per annum. • Ongoing government costs associated with increased compliance requirements.	• $5,000 to $100,000 per annum due to repeated need for updating forms and monitoring changes. • Ongoing government costs associated with implementing changes every year.	• 20,000 to $100,000 per annum due to repeated need for updating forms and monitoring changes. • Ongoing government costs associated with consultation and implementing changes every 3 to 5 years.
Impact on capital raising (10%)	-2.0	-1.5	-1.5
	• Maximum reduction in the prospective investors who qualify as wholesale investors, reducing the total capital raised.	• Some reduction in the prospective investors who qualify as wholesale investors, reducing the total capital raised.	• Likely to see a gradual reduction in the prospective investors who qualify as wholesale investors, reducing the total capital raised but not as much as Option 1.
Access to higher risk-adjusted returns and diversified investments (10%)	-2.0	-1.0	-1.0
	• Maximum reduction in prospective investors who can no longer access opportunities for higher returns.	• Some reduction in prospective investors who can no longer access opportunities for higher returns.	• Likely to see a gradual reduction in prospective investors who can no longer access opportunities for higher returns.
Average score	**0.9**	**0.4**	**0.3**

Source: PwC analysis

4.5.1 Analysis by stakeholders

To provide a more detailed analysis of the impact on stakeholders, a disaggregated scoring of the criteria by stakeholder group is included in Table 7 (next page).

Table 7:Results of the multicriteria analysis by stakeholder

	Option 1 FSC Proposal	Option 2 Indexation	Option 3 Re-assessment
Increased consumer protection	+2.5	+1.5	+1.5
Reduced opportunity for returns	-2.0	-1.0	-1.0
Average score for investors	**+0.3**	**+0.3**	**+0.3**
One-off costs	-1.5	-1.5	-2.0
Higher ongoing compliance costs	-1.0	-2.0	-3.0
Average score for fund managers	**-1.3**	**-1.8**	**-2.5**
One-off costs to advisors	-1.5	-1.5	-2.0
Higher ongoing compliance costs	-1.0	-1.0	-1.0
Average score for advisors and accountants	**-1.3**	**-1.3**	**-1.5**
Higher cost of funds	-2.0	-1.5	-1.5
Average score for recipients of funds	**-2.0**	**-1.5**	**-1.5**
One-off costs to government	-1.0	-1.0	-1.0
Higher ongoing cost to government	-1.0	-2.0	-2.0
Average score for government	**-1.0**	**-1.5**	**-1.5**

Source: PwC analysis

Overall impact on investors

Based on the multicriteria analysis, all the proposed options offer greater protection compared to the base case:

- Option 1 provides greater consumer protection as it results in the biggest reduction in the potential pool of investors who would qualify as wholesale investors by default. Option 1 also includes steps to improve assessment of financial literacy under the sophisticated investor test.
- Option 2 and Option 3 are likely to reduce the pool of people who can qualify as individual investors, however there is a greater degree of uncertainty for individual investors under these options as CPI is unknown under Option 2 and Option 3 requires periodic re-assessment of the wholesale investor test.
- As a result of the smaller pool of wholesale investors, Option 1 fares the lowest when considering the potential impact on higher returns and diversification that can typically be accessed through wholesale investments. Options 2 and 3 are also likely to see some reduction in the number of individuals who can access the benefits of wholesale investment products.

Overall, all options provide broadly similar outcomes for investors when considering the degree of consumer protection and opportunity for higher risk adjusted returns.

Overall impact on fund managers

Fund managers are likely to see impact on their revenue and costs across all options.

- Option 1 is likely to see the greatest decline in revenue as the pool of potential wholesale clients diminishes the most under that option. Option 2 and 3 are likely to see some reduction in the pool of wholesale clients, and thus a relatively reduced impact on revenue.
- As indicated by responses to the survey, all the proposed options would incur one-off substantive compliance costs as they would require legal advice, updating documents and forms, communicating with clients and training staff. Option 3 is likely to incur the highest one-off costs due to changes every time the policy is re-assessed.

- All proposed options will also likely incur higher ongoing compliance costs due to greater need for recordkeeping and communicating changes with the registry. Responses to the survey suggested that Option 2 and Option 3 are likely to have the highest ongoing costs as advisors will have to continually update processes every time a change is made. Option 3 has the additional uncertainty of changes every time the policy is re-assessed and is likely to incur additional costs associated with monitoring and considering changes. There are also likely to be ongoing costs associated with catering to more retail investors due to increased governance and regulatory burden.

Overall, the impact on fund managers is likely to be highest under Option 3, followed by Option 2 and Option 1.

Overall impact on financial advisors and accountants

Financial advisors and accountants are likely to incur costs under all the proposed options.

- All options will result in one-off costs for accountants who will need to implement changes associated with revised thresholds.
- Accountants and advisors will need to monitor and update changes periodically under Option 2 and Option 3. There are also likely to be ongoing costs for all options associated with catering to more retail investors due to increased governance and regulatory burden.

Overall, the cost to financial advisors and accountants is likely to be greatest under Option 3, followed by Option 2 and Option 1.

Overall impact on recipients of funds

- All options are likely to result in a negative impact for recipients of wholesale funds due to the reduction in the pool of wholesale investment clients and associated funds under management. The analysis considers the change in access to wholesale funds as a function of the change in the pool of investors. As a result, the impact will be greatest under Option 1 followed by Option 2 and Option 3.

Overall impact on government

- The one-off costs to government include the cost of implementing changes, communicating policy reform and updating the compliance and governance requirements. These are likely to be broadly similar across all options.
- The government is also likely to incur ongoing costs associated with the proposed options, including the cost of any subsequent changes which are likely to be higher for Option 2 and Option 3. Ongoing costs to government will also include the cost of more investors moving from the wholesale market to the retail market, thus being able to access dispute resolution mechanisms through ASIC and AFCA.

Overall, the cost to government is likely to be highest for Option 3, primarily due to the need for periodic re-assessment, followed by Option 2 and Option 1.

4.5.2 Impact of not grandfathering arrangements

As shown in Table 8, a sensitivity analysis has been completed to understand how the outcome of the MCA would change if there were no grandfathering provisions. All options would incur higher costs associated with re-assessing existing clients per the new thresholds. There would also be an impact on access to higher risk adjusted returns and ability to raise capital as existing wholesale investors would be forced out of their investments.

Table 8: Results of the multicriteria analysis if arrangements are not grandfathered

	Option 1	Option2	Option 3
Consumer protection (60%)	2.5	1.5	1.5
	• No change is expected to the level of consumer protection provided under any of the options compared to the central scenario analysis.		
Transition costs (10%)	-2.7	-2.7	-2.7
	• Survey responses indicated additional costs if current arrangements were not grandfathered due to increased complexity, additional customer engagement and a requirement to re-classify all existing investors.		

	Option 1	Option2	Option 3
	• The costs would be broadly similar under Option 1, Option 2 and Option 3 as regardless of how much the threshold changes by it would require a re-assessment of all existing investors. • Survey responses indicated that costs could be up to $250,000 per business depending on the detail of how the reform is implemented. • Government would also incur higher costs due the additional complexity.		
Ongoing costs (10%)	-2.7	-3.0	-3.0
	• Survey responses indicated additional ongoing costs if current arrangements are not grandfathered. The costs would be particularly high if the funds must force redemption of funds for investors who no longer qualify. The survey indicated costs could be up to $3.8 million per annum depending on how many clients must be re-classified. • Similar to the central analysis scenario, the compliance burden will be the highest for Option 2 and Option 3 due to the period changes.		
Impact on capital raising (10%)	-3.0	-2.0	-2.0
	• Under all options, there will likely be a negative impact on the ability to raise capital if current arrangements are not grandfathered. The impact will be worse if funds have to be redeemed before maturity as a result of forcing existing investors out. • The impact is likely to be worst under Option 1 due to the greater change in threshold.		
Access to higher risk-adjusted returns and diversified investments (10%)	-3.0	-2.0	-2.0
	• If current arrangements are not grandfathered, existing wholesale investors will miss out on opportunities for higher returns. Moreover, they may be forced to pull their investments out. • Option 1 will see the largest impact due to the greater change in threshold.		
Average score	**0.4**	**-0.1**	**-0.1**

Source: PwC analysis

Appendices

Appendix A Methodology used to analyse HILDA data

See attached report.

Appendix B International comparison of wholesale investor tests

Table 9 International comparison of wholesale investor test equivalent

Jurisdiction	Requirements
United States	An accredited investor satisfies one or more of the following requirements: • Income exceeds $200,000 (AUD$290,000) in each of the two most recent years (or $300,000 (AUD$430,000) in joint income with a person's spouse) and who reasonably expects to reach the same income level in the current year; • Net wealth exceeds $1 million (AUD$1.43 million), excluding value of primary residence • Individuals who hold in good standing one of the prescribed financial professional licenses • Individuals who are 'knowledgeable employees' of a private fund.
Canada	An accredited investor satisfies one or more of the following requirements: • Financial assets worth more than CAD$1 million (AUD$1.09 million) (alone or with spouse) before taxes but net of related liabilities • Net assets of at least CAD$5.0 million (AUD$5.4 million) (alone or with spouse) • Net income before taxes exceeded CAD$200,000 (AUD$220,000) (or CAD$300,000 (AUD$330,000) in joint income with a spouse) in both of the last two years and who expects to maintain at least the same level of income this year • An individual who currently is, or once was, a registered adviser or dealer, other than a limited market dealer.
United Kingdom	Individuals can be classified as elective professional clients based on the following conditions: • Individuals must request and receive a statement acknowledging they have been assessed by a firm as having the expertise, experience, and knowledge to be capable of making their own investment decisions and understand the risks involved. • Firms covered by the Markets in Financial Instruments Directive (MiFID) must be satisfied that the client satisfies additional criteria including measures of professional experience and knowledge in financial services, and size of financial investment portfolio. In regard to the 'financial promotion' of a financial product or service (which are communications that contain an invitation or inducement to engage in a financial product or service), there are further exemptions to the regulatory safeguards for investors based on wealth and professional experience measures. These include: • Certified high net worth investors who have signed a statement within the past 12 months confirming they have an annual income of at least £100,000 (AUD$183,000), or

<table>
<tr><th>Jurisdiction</th><th>Requirements</th></tr>
<tr><td></td><td>have net assets of at least £250,000 (AUD$458,000) (excluding their primary residence, rights under a qualifying contract of insurance, or pensions), and that they accept the risks of this classification.</td></tr>
<tr><td>European Union</td><td>An individual qualifies as an Elective Professional Client must satisfy all of the following:
The ‘Qualitative Test’: The firm undertakes an adequate assessment of the expertise, experience and knowledge of the client that gives reasonable assurance that the client is capable of making their own investment decisions
The ‘Quantitative Test’: Client meets at least two of the following:
has carried out transactions of significant size on the relevant market at an average frequency of 10 per quarter over the previous four quarters.
has financial portfolio exceeding EUR 500,000 (AUD$800,000).
works or has worked in the financial sector for at least one year.
state in writing that it wishes to be treated as a professional client and the firm must give the clear warning of the protections that client may lose</td></tr>
<tr><td>Hong Kong</td><td>Individual professional investors must have a portfolio of at least HK$8 million (AUD$1.47 million) (or its foreign currency equivalent). The portfolio (including a share of a portfolio) of an individual is ascertained by reference to one or more of the following documents issued or submitted within 12 months before the relevant date:
a statement of account or a certificate issued by a custodian
a certificate issued by an auditor or a certified public accountant, or
a public filing submitted by or on behalf the individual.
Hong Kong introduced a streamlined approach for very high net worth individuals known as sophisticated professional investors who must have:
a portfolio of at least HK$40 million (AUD$6.85 million AUD) or its equivalent in any other currency, or
net assets of at least HK$80 million (AUD$13.7 million AUD) or its equivalent in any other currency, excluding primary residence, and
AND
hold one of the following:
a degree or post-graduate diploma in accounting, economics or finance, or a related discipline
a professional qualification in finance (e.g. CFA, CIIA, CPWP, CFP, or other comparable qualifications)
have executed at least five transactions within the past three years in the same category of investment products, and
Not be categorised as a conservative client (e.g. whose investment objective is capital preservation and/or seeking regular income).</td></tr>
</table>

Jurisdiction	Requirements
Singapore	An accredited investor satisfied one of the following requirements: • Income in the preceding 12 months is not less than SGD300,000 (AUD$320,000) • Net personal assets exceeding SGD2 million ($2.1 million AUD) in value, of which the net value of the investor's primary place of residence can only contribute up to SGD1 million (AUD$1.05 million) • Net Financial Assets exceeding SGD1 million (AUD$1.05 million) in value Joint accounts can also qualify for Accredited Investor status if at least one joint account holder qualifies as an Accredited Investor and all other holders must opt in for Accredited Investor status for the joint account.

Note: AUD conversions placed in brackets are based on 10-year averages, rounded to the nearest ten-thousandth, sourced from Haver Analytics.

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