



HERBERT
SMITH
FREEHILLS

Australian Law Reform Commission
PO Box 12953, George Street Post Shop,
Queensland 4003
financial.services@alrc.gov.au

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By online submission form

Dear Australian Law Reform Commission

Submission – Financial Services Legislation: Interim Report A (ALRC Report 137, 2021)

1 Introduction

This submission is made by Herbert Smith Freehills (**HSF**) in response to the Australian Law Reform Commission (**ALRC**) report, *Financial Services Legislation: Interim Report A* (Report 137, 2021) (**Interim Report**), which was tabled in Parliament by the Attorney-General of Australia on 30 November 2021.

Question A16 proposes to simplify the definition of ‘retail client’ as contained in s 761G of the *Corporations Act 2001* (Cth):

- (a) by removing
 - (1) subsections (5), (6) and (6A), being provisions in relation to general insurance products, superannuation products, RSA products, and traditional trustee company services; and
 - (2) the product value exception in sub-section (7)(a) and the asset and income exceptions in sub-section (7)(c); or
- (b) in some other manner.

Question A17 asks what conditions or criteria should be considered in respect of the sophisticated investor exception in s 761GA of the *Corporations Act 2001* (Cth).

We are grateful for the opportunity to submit a response to these proposals and we wish to address questions A16(a) and (b), and will briefly consider question A17, in this submission.

HSF is an international law firm with 27 offices located around the globe and which specialises in, amongst other things, financial services and financial services regulation. We regularly advise in relation to the definitions of ‘retail client’, ‘wholesale client’ and ‘sophisticated investor’, together with the ramifications of those definitions for investors and financial service providers (**FSPs**) alike.

2 Executive Summary

In our view, the proposal to simplify the definitions in this area (and more broadly across the Interim Report) is very welcome. As noted in the Interim Report, the myriad of definitions relating to the same concept, and the complexity of there being numerous regulations prescribing the detail and application of those definitions is confusing and unnecessarily complex for industry participants, and has only increased in complexity over time.

That said, for the reasons set out in this submission, we do not necessarily agree that simplifying the definition of retail client in the manner set out in question A16 will either resolve that complexity or will serve one of the key purposes of the Interim Report - to

bring the distinction between retail and wholesale clients in line with the legislative intention contained in the Financial Services Reform Bill 2001 (Cth) (**FSR Bill**).

It is our submission that changing the definition of 'retail client' in the manner proposed in question A16 could have adverse consequences for industry participants, and that the purpose of the FSR Bill could be better implemented through:

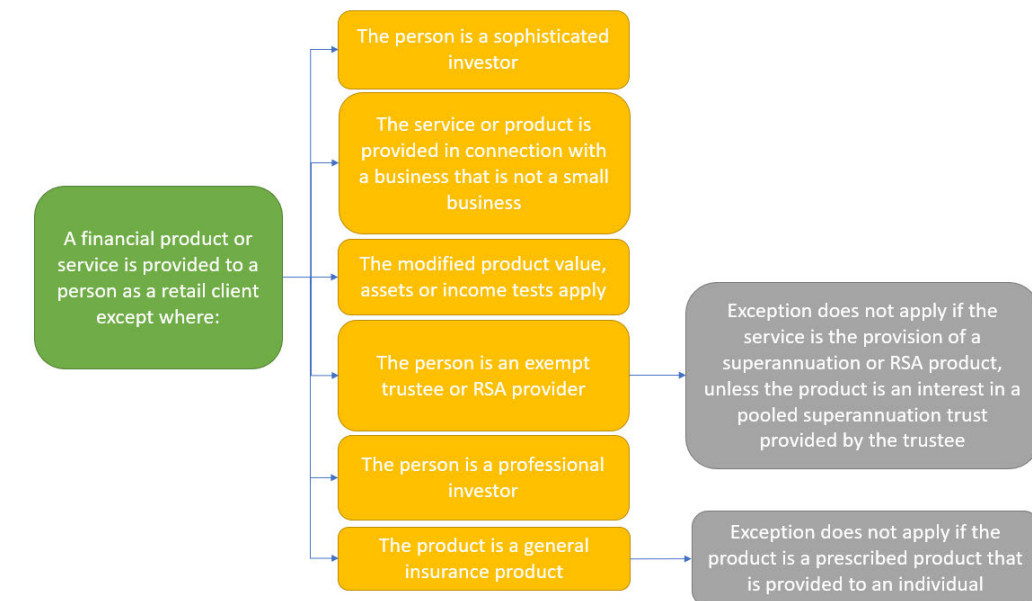
- (a) retaining, but updating, the existing quantum-based exemptions;
- (b) ensuring that certain categories of investors are deemed wholesale clients, irrespective of the type of financial product; and
- (c) making minor amendments to the sophisticated investor tests.

For the reasons set out in this document, we submit that the general insurance product provisions should be largely left alone.

3 Our proposed retail client/wholesale client distinction

As the ALRC noted in its Interim Report, there is need for simplification of the distinction between wholesale clients and retail clients. Part of the confusion, in our view, stems from being able to clearly identify whether a person is a retail client, a wholesale client, a sophisticated investor, or simply not a retail client (and the ramifications of each of these categorisations). Our submission, which is broadly consistent with the approach taken in the Interim Report, is to create two definitions: retail clients and wholesale clients. We have summarised our proposed distinction in the table below:

Figure: Suggested model for the 'retail client' definition



Key:



As can be seen from the above figure, the structure we have proposed is broadly consistent with the approach in the Interim Report with two key differences:



- (1) preserving the quantum-based tests, but providing for them to be updated; and
- (2) ensuring that certain categories of investors are deemed wholesale clients, irrespective of the type of financial product.

We also propose amending the definition of professional investor to include a limb related to the product value, albeit for a higher value than the test included in the quantum-based exemption. Each of these differences are explained further below.

3.1 Modernising the quantum-based tests

We note the concerns in the Interim Report that the quantum of each of the product value and the assets/income exceptions have not been updated over time and are now considered to be too low.

It would be sensible for these quanta to be reviewed and where relevant increased periodically and to provide for a method to do this. We suggest that such an approach is superior to removing those exemptions altogether. It is our understanding that a number of FSPs rely on these exemptions and that a number of investors who fall within this category are able to access a wider range of products because of these exceptions. To remove those exceptions, resulting in such investors being classified as retail clients, might, theoretically, result in those clients being afforded more protections. It is also quite possible that FSPs will simply stop offering such products to them, limiting the range of products available to such persons and reducing investors' choices.

In our view, this outcome would not be in line with the rationale underpinning the FSR Bill. Those exceptions were available because it was considered that wholesale clients are better informed and better able to assess the risks involved in financial transactions. Well informed or advised investors should not now be barred from products they are familiar with or in which they have invested for years.

As such, it is our submission that the product value and assets/income tests be preserved, but their quanta be updated to a reasonable level, and there be provision in the law to increase that quanta, for example, in line with CPI or with periodic updates as occurs in relation to the value of a penalty unit.

If the retention of the quantum-based exemptions is not palatable then we would welcome the opportunity to discuss alternative solutions which might preserve elements of these quantum-based exemptions, including, for example, incorporating them into an existing exemption.

3.2 Considering a revised sophisticated investor test

We note that the current sophisticated investor test in section 761GA involves an assessment by an AFSL holder that the client has such previous experience in using financial services, and investing in financial products, that allows it to assess the key aspects and risks of the service or product being offered. As stated in the Interim Report, we acknowledge that this exemption is not used often in practice and that it is likely that the subjective element of this test contributes to its lack of utility. We submit that the subjective element of the test could be replaced by an objective list of factors and attributes that an AFSL holder is required to run through with the client, which could be prescribed by an industry standard checklist and could be tailored for certain categories of product or service.

As noted in the Interim Report, a key concern is where clients invest in products that are clearly not suited to them, with concern that inappropriately identifying clients as wholesale clients avoids that client being offered the protections afforded to retail clients. These protections include the provision of prospectuses or product disclosure statements and the new design and distribution obligations, which are designed to promote the provision of suitable products to consumers. The objective checklist could include details on the differences between the rights of wholesale clients and retail clients in order to better inform clients as to their position. The checklist could also provide examples of



scenarios where clients have been disadvantaged by being inappropriately treated as a wholesale client, in order to illustrate the importance of this distinction.

Separately, we submit that section 761G could be made even simpler through including a sophisticated investor limb in the professional investor definition, rather than having both terms operating separately.

3.3 Reducing the limitations to the exclusions

It is our view that the limitations for certain types of financial products add an unnecessary extra level of complexity.

We acknowledge that the FSR Bill specifically identifies certain types of product that should always be deemed to be provided to a retail client and, therefore, the proposals in the Interim Report preserve this position. However, we submit that, in a general sense, not incorporating a product-by-product level of classification into the definitions would make the exemptions less complex, whilst still ensuring that an individual (unless that individual is wealthy enough to qualify a professional investor) will be treated as a retail client for these products.

General insurance products

However, we do not propose to follow this approach for general insurance products. For the reasons set out below, we propose that the approach to general insurance products is kept the same as the current law, save for one change relating to the treatment of small businesses. As noted in the Interim Report, the current law prescribes a limited number of general insurance products that are deemed to be provided to retail clients. This reflects the reality of the commercial insurance market wherein businesses purchase insurance as wholesale clients, with the extremely rare and few exceptions of products purchased by businesses which are deemed to be provided to retail clients. The approach to remove this and have all general insurance products deemed to be provided to retail clients unless that person is acquiring the product as a (non-small) business certainly reduces complexity, but would represent a fundamental shift in the current commercial industry, rendering all general insurance products potentially made available to retail clients and therefore enliven the significant compliance and other obligations which current providers of commercial general insurance products are simply incapable of complying with (given their current operating models which do not include the provision of products currently deemed to be provided to retail clients at all). Further, this could have adverse and arbitrary consequences, such as:

- (a) in the case of a business acquiring insurance, the revised rule would mean that a highly sophisticated enterprise with internal risk and insurance management resources supported by a professional independent insurance brokerage acting on its behalf will be treated as a retail client for all of its insurances, merely because of the number of employees it has (noting for many organisations, there are multiple different legal entities which benefit from insurance arrangements put in place at a group level, but the entity responsible for arranging such insurances may have few, if any, employees). Conversely, a simple product manufacturer with 101 employees and no expertise or external support available to it in relation to insurance will be treated as a wholesale client for all of its insurances. This could lead to a number of regulations being passed trying to provide exceptions for products that clearly were not meant to be covered, which would add complexity to the area;
- (b) also, in the case of a business acquiring insurance, the number of employees is not static during any given year and could lead to inconsistency in the protections afforded to the business year on year as the insurances are renewed;
- (c) by rendering all insurance acquired by individuals as being acquired by retail clients, this could adversely affect the market for insurance products that are



only acquired in connection with a business, but are acquired for the benefit of individuals, for example, directors' and officers' liability (**D&O**) insurance. Businesses are already struggling to obtain D&O insurance on commercial terms. A significant regulatory change in that sector could have adverse consequences for insurers, intermediaries and business consumers;

- (d) rendering an Australian financial service licensee (such as the insurer or other intermediary, including but not limited to an insurance broker) responsible for performing, and presumably monitoring on an ongoing basis, the status of a client as either retail or wholesale creates a significant liability risk exposure that would be unjustifiable without being able to rely on client attestations in order to comply with the various and significant protections afforded to retail clients; and
- (e) there is also a risk that general insurance products that are not on the current list, but are provided to individuals, might now be caught. This could be very damaging for providers of that insurance product (with increased costs of compliance or a reduced customer base) and, in turn, on those who obtain it (as insurance premiums will rise to cover the increased costs of compliance, or the individual may have fewer insurance providers to choose from as a result of some electing not to offer to retail clients). As noted in the Interim Report, the solution would be to set regulations to sweep up those affected products, but this would cut across the "making legalisation simpler" approach.

For the reasons set out above, we propose removing the small business element of the current test, so that a general insurance product will only be deemed to be acquired by a retail client where it is:

- (a) a product of the type prescribed by the current regulations; and
- (b) acquired by an individual for personal, domestic or household use. In our view, this would simplify the provision and would avoid the arbitrary outcomes outlined above.

Life insurance products

We note that life insurance products can be sold to corporations as well as individuals.

When sold to corporations, they are often designed to provide insurance benefits to employees (for example, salary continuance), thereby facilitating individuals obtaining cover under the group policy arranged by the employer. Group life insurance arrangements are also commonly held by superannuation trustees for the benefit of members.

When sold to individuals, directly or via a financial adviser, the policyowner is typically, but not always, the life insured. Sometimes an individual may acquire life insurance in respect of the life of another person. Increasingly, new income stream products are being sold by life companies to individual retirees.

When sold to individuals who are also the lives insured, there are grounds to treat such individuals as retail clients, similarly to the treatment of superannuation.

When contemplating simplification of the definitions of retail and wholesale clients, we submit that care should be taken not to inadvertently capture life insurance products that are currently outside the regime, and are regulated entirely separately.

4 Amendment to the professional investor test

If the product value exception is removed, we submit that the definition of professional investor be amended to incorporate a new limb relating to the value of the product or service.



In our view, this would be in keeping with the rationale in the FSR Bill that those investing more money are presumed to have the expertise and/or access to professional advice to justify their being treated as wholesale.

We submit that the value for this limb should be set higher than the current product value test for wholesale clients but lower than the assets test that applies to professional investors. The product value test that forms part of the professional investor definition should also be capable of periodic review, for example, annually in line with CPI or periodically.

Thank you for providing us the opportunity to comment on the Interim Report. If you would like to discuss the matters raised in this submission, please contact any of us at the details below.

Yours sincerely

[Redacted signature]

Fiona Smedley
Partner
Herbert Smith Freehills

[Redacted contact details]

Michael Vrisakis
Partner
Herbert Smith Freehills

[Redacted contact details]

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1 Introduction

This submission is made by Herbert Smith Freehills (**HSF**) in response to the Australian Law Reform Commission (**ALRC**) report, *Financial Services Legislation: Interim Report A* (Report 137, 2021) (**Interim Report**), which was tabled in Parliament by the Attorney-General of Australia on 30 November 2021.

Proposal A20 proposes to clarify the meaning of the phrase 'efficiently, honestly and fairly' in section 912A(1)(a) of the *Corporations Act 2001* (Cth) (**Corporations Act**) by:

- (a) separating the words 'efficiently', 'honestly' and 'fairly' into individual paragraphs so that each term in that composite phrase imports a standalone obligation;
- (b) replacing the word 'efficiently' with 'professionally', in accordance with the meaning established by case law; and
- (c) inserting an explanatory note containing examples of conduct that would fail to satisfy the 'fairly' standard.

We are grateful for the opportunity to submit a response to these proposals, and we wish to address proposals A20(a) and (b) in this submission.

HSF is an international law firm with 27 offices located around the globe and which specialises in, amongst other things, financial services and financial services regulation. We have closely followed the developments in respect of the interpretation of the phrase 'efficiently, honestly and fairly'.

In our view, the treatment of the terms 'efficiently', 'honestly' and 'fairly' as creating standalone obligations is consistent with recent trends in the case law. This recent shift in case law has given rise to considerable ambiguity across the industry and accordingly, we welcome legislative clarification in this regard.

However, with respect to proposal A20(b), we submit that the best replacement of the term 'efficiently' is 'competently', rather than 'professionally'.

2 Standalone obligations (Proposal A20(a))

As the ALRC noted in its Interim Report, conflicting case law has made it unclear whether the terms in the phrase 'efficiently, honestly and fairly' are to be understood in composite or as standalone obligations. However, there is, in our view, a clear trend in the contemporary case law supporting the view that the 'efficiently, honestly and fairly' obligation comprises three standalone obligations.



In *Australian Securities and Investment Commission v Westpac Securities Administration Ltd* (2019) 272 FCR 170, Allsop CJ stated (at [170]):

The phrase [efficiently, honestly and fairly] has been held to be compendious as a single composite concept, rather than containing three discrete behavioural norms. That said, if a body of deliberate and carefully planned conduct can be characterised as unfair, even if it cannot be described as dishonest, such may suffice for the proper characterisation to be made.

As the ALRC noted, the Chief Justice reserved the question of whether the phrase is compendious for another occasion where the issue could be fully argued. O'Bryan J more firmly rejected the compendious view, stating (at [426]):

*...it seems to me that there is no reason why it cannot carry its ordinary meaning which includes an absence of injustice, even-handedness and reasonableness. As is the case with legislative requirements of a similar kind, such as provisions addressing unfair contract terms, the characterisation of conduct as unfair is evaluative and must be done with close attention to the applicable statutory provision: cf *Paciocco v Australia and New Zealand Banking Group Ltd* (2015) 236 FCR 199 at [364]. It seems to me that the concepts of efficiently, honestly and fairly are not inherently in conflict with each other and that the ordinary meaning of the words used in s 912A(1)(a) is to impose three concurrent obligations on the financial services licensee: to ensure that the financial services are provided efficiently, and are provided honestly, and are provided fairly.*

Following the decision in *Australian Securities and Investment Commission v Westpac Securities Administration Ltd* (2019) 272 FCR 170, judges of the Federal Court have taken differing approaches to the scope of the obligation.

In *Australian Securities and Investments Commission v AGM Markets Pty Ltd (in liquidation) (No 3)* (2020) 275 FCR 57 at [506], Beach J reverted to the previous historical and conventional judicial interpretation, holding that the words 'efficiently, honestly and fairly' are to be read as a compendious 'indication requiring a licensee to go about their duties efficiently having regard to the dictates of honesty and fairness, honestly having regard to the dictates of efficiency and fairness, and fairly having regard to the dictates of efficiency and honesty'. His Honour referred to these principles again in *Australian Securities and Investments Commission v Commonwealth Bank of Australia* [2020] FCA 790 at [50].

More recently in *Australian Securities and Investments Commission v MobiSuper Pty Ltd* [2021] FCA 855, Jackson J adopted a somewhat 'hybrid' approach, by making an assessment of the obligation both as a compendious obligation and as three separate obligations. However, significantly, his Honour described the breach in terms of the fairness and honesty elements, ignoring the efficiency element even when applying the singular test. Following the approach taken by Allsop CJ in *Australian Securities and Investment Commission v Westpac Securities Administration Ltd*, his Honour said (at [49]):

The issue of interests in the MobiSuper Fund in those circumstances would not have been provided 'efficiently, honestly and fairly', considered as a compendious term and (at least) not honestly and not fairly, considered as separate concepts...But his Honour's words do capture the essence of the lack of honesty, fairness and sound ethical dealing which would have occurred in the present case if the risks I have described had come to pass.

In *Australian Securities and Investments Commission v RI Advice Group Pty Ltd (No 2)* [2021] FCA 877, despite noting that it was unnecessary to resolve the question of whether 'efficiently, honestly and fairly' is a compendious expression, Moshinsky J found that RI Advice had breached the obligation by failing to have adequate compliance,



monitoring and supervision frameworks in place to ensure financial advice was being provided appropriately. That is, his Honour appeared to premise the breach on the respondent's failure to satisfy the 'efficiency' limb, despite an absence of the form of morally culpable conduct that is contemplated by the standards of honesty and fairness.

These developments are indicative, in our view, of a judicial trend whereby the Federal Court is prepared to apply the 'efficiently, honestly and fairly' obligation in a malleable way, which is not limited by compendious interpretation. Proposal A20(a) is consistent with this trend. Given the recent uncertainty across industry that has arisen due to this shifting judicial trend, we welcome any clarification of the scope of the 'efficiently, honestly and fairly' obligation.

3 The 'efficiency' limb (Proposal A20(b)) – 'Competently' vs 'Professionally'

We submit that the word 'efficiently' should be replaced with the word 'competently'.

At paragraph [13.73] of its Interim Report, the ALRC suggests that 'professionally' or 'professionalism' as referred to in section 760A(b) ('fairly, honestly and professionally') and the general objects of Chapter 7 should be adopted in section 912A instead of 'efficiently.'

We respectfully submit that, consistently with the ALRC's stated objective at paragraph [13.71] of the Interim Report, 'competently' would better accord with the meaning that has been attributed to the word 'efficiently' by the courts, including in the following cases:

Australian Securities and Investments Commission v Camelot Derivatives Pty Ltd (in liq) (2012) 88 ACSR 206

Having regard to Young J's comments concerning the meaning of the phrase 'efficiently, honestly and fairly' in *Story v National Companies and Securities Commission* (1988) 13 NSWLR 661, Foster J accepted that '[t]he words "efficiently, honestly and fairly" connote a requirement of **competence** in providing advice and in complying with relevant statutory obligations... The word "efficient" refers to a person who performs his duties efficiently, meaning a person is adequate in performance, produces the desired effect, is capable, **competent** and adequate' (at [69], emphasis added).

Australian Securities and Investments Commission v Avestra Asset Management Ltd (In Liq) (2017) 348 ALR 525

Beach J said that the phrase 'efficiently, honestly and fairly' 'connotes a requirement of **competency** in providing advice and in complying with relevant statutory obligations... the word "efficient" entails that the person is adequate in performance and is **competent**' (at 561, emphasis added).

Australian Securities and Investments Commission (ASIC) v AGM Markets Pty Ltd (In Liq) (No 3) (2020) 275 FCR 57

Similarly, in this case, Beach J adopted the words of Young J in *Story v National Companies and Securities Commission* (1988) 13 NSWLR 661 (see below), stating that 'the word "efficiently" refers to a person who performs his duties efficiently, meaning the person is adequate in performance, produces the desired effect, is capable, **competent** and adequate. Inefficiency may be established by demonstrating that the performance of a licensee's functions falls short of the reasonable standard of performance by a dealer that the public is entitled to expect' (at [508], emphasis added).



Australian Securities and Investment Commission v Westpac Securities Administration Ltd (2019) 272 FCR 170

O'Bryan J read the term 'efficiency' to mean '**competent**, capable and having and using the requisite knowledge, skill and industry' (at [426], emphasis added).

This is despite O'Bryan J expressly acknowledging (at [397]) that the purpose of Chapter 7 is, broadly, to promote 'fairness, honesty and **professionalism**' by those who provide financial services' (emphasis added).

In his Honour's view, 'competent' was 'the meaning well adapted to the statutory provision' itself (at [426]).

It is worth noting that section 912A(1)(a) was introduced by the *Financial Services Reform Act 2001* (Cth), and under the original draft of the Financial Services Reform Bill 2001 (Cth), the provision only required that financial services be provided 'competently and honestly'. As Gleeson J noted in *Australian Securities and Investments Commission v Westpac Securities Administration Ltd* (2018) 133 ACSR 1 at [413], the wording was replaced with the phrase 'efficiently, honestly and fairly' to reflect the equivalent provision in the predecessor Act, the *Corporations Law* (Cth). The Supplementary Memorandum to the *Financial Services Reform Bill 2001* (Cth) stated (at [3.74]):

Paragraph 912A(a) currently obliges licensees to provide services 'competently and honestly'. It is proposed to amend this paragraph to require licensees to provide services 'efficiently, honestly and fairly' (in line with the wording of the licensing obligations in Parts 7.3 and 8.3 of the current Corporations Law) (see proposed item 64).

As Gleeson J recognised (at [416]), the term 'efficiently, honestly and fairly' in Parts 7.3 and 8.3 of the Corporations Law appears to have had its origin in section 60 of the Security Industry (New South Wales) Code, which enabled the National Companies and Securities Commission to revoke a dealer's licence if the Commission had reason to believe a licence holder 'has not performed the duties of a holder of such a licence efficiently, honestly and fairly'.

In *Story v National Companies and Securities Commission* (1988) 13 NSWLR 661, Young J considered the meaning of 'efficiently, honestly and fairly' within the meaning of the Code. His Honour said that 'someone is an efficient person or performs his duties efficiently if he is adequate in performance, produces the desired effect, is capable, **competent** and adequate' (at 672, emphasis added). At the licensee level, his Honour considered that 'inefficiency' would be established by demonstrating that the performance of the licensee's functions fell short of the reasonable standard of performance objectively expected of them (at 679).

In adopting the phrase 'efficiently, honestly and fairly', the legislature imported the concepts of 'adequacy' and 'competence' into section 912A(1)(a) of the Corporations Act, and as is evident in the list of cases above, Young J's construction has been applied repeatedly in the context of section 912A(1)(a).

The current statutory framework in Chapter 7 of the Corporations Act is otherwise already familiar with the term 'competence'. It is used in respect of the standards expected of financial services licensees under subsections 912A(1)(e) and 912A(1)(f) of the Corporations Act. By contrast, the standard of acting 'professionally' is not used at all to set the normative standard for any obligation in Chapter 7 of the Corporations Act. We therefore consider that the term 'professionally' will introduce additional uncertainty into this regime through the introduction of a new concept of conduct.

It must also be noted that the standard expected under section 912A(1)(a) is a sliding scale, the content of which varies according to the nature, scale and complexity of the licensee. This has been emphasised by ASIC in Regulatory Guide 104 *AFS licensing*:



Meeting the general obligations. The standard of 'competence' is intuitively less fixed than one of 'professionalism' and therefore accords with this characteristic of section 912A(1)(a).

Moreover, if, as is proposed, the standard of 'professionalism' is to be construed as a standard of independent force, it may attract civil penalty provisions for a trivial dereliction of duty, or an immaterial breach of a code of 'professionalism'. Using 'competency' as the yardstick would mean that a breach must involve conduct that is incompetent, which seems to be a more reasonable basis for invoking and justifying a civil penalty provision. The term 'competency' also houses sufficient fluidity to afford a court some degree of discretion to treat lower level dereliction as something less than incompetency.

Thank you for providing us the opportunity to comment on the Interim Report. If you would like to discuss the matters raised in this submission, please contact Michael Vrisakis or Fiona Smedley using the details below.

Yours sincerely

Michael Vrisakis
Partner
Herbert Smith Freehills



Fiona Smedley
Partner
Herbert Smith Freehills



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