

24th August 2014

Mr. David Murray AO,
Chairman,
Financial System Inquiry
GPO Box 89
SYDNEY NSW 2001

Dear Mr. Murray,

SUBMISSION TO THE FINANCIAL SERVICES INQUIRY

Summary

Current regulations that distinguish between retail and wholesale clients/investors unfairly and unreasonably discriminate against retail investors, particularly with regard to direct investment in corporate bonds. This is an impediment to reduction of investment risk and provision of income streams for self-managed superannuation funds, particularly during the pension phase of superannuation. This is also an impediment to the development and growth of an efficient bond market in Australia, which is highly relevant to all self-managed superannuation funds.

It is recommended that the distinction between retail and wholesale investors as set out in Section 761G and 761GA of the Corporations Act 2001 (Cth) be abolished but that retail/consumer protection continues be applied to all investors except professional investors (fund managers, etc) or those who wish to opt out.

It is further recommended that the requirement of ASIC's Information Sheet 99 (non disclosure of credit ratings to retail clients) be abolished.

Background

It has been continually recognized that self-managed superannuation funds (SMSF) have inadequate asset allocation to fixed income products. The Interim Report of this Financial Services Enquiry has already pointed out the lack of financial products to minimize longevity risk in pension income and investment in bonds can assist in overcoming this. Part of the reason for the lack of direct investment in the corporate bond asset class is because of the small corporate bond market in Australia but equally because retail investors (which includes most SMSFs) are denied, by legislation, access to the full range of Australian corporate bonds that are available. Most of the Over-the-Counter (OTC) corporate bonds are only available to wholesale investors.

Take, for example, the current offering by a major OTC bond broker. Sixty eight percent (68%) of bonds on offer in the secondary market are only available to wholesale investors of which 90% are considered investment quality (i.e. S&P rated BBB or above). Of the remaining 32% of OTC bonds on offer to retail (and wholesale) investors, only 66% are considered investment grade. Thus, overall, only 21% of investment grade bonds on offer are available to retail investors! Yet nearly all, wholesale OTC corporate bonds are issued by major, stable, listed companies whose financial situation can be readily obtained and where broker research is available. Retail investors should not be prevented from investing in wholesale corporate bonds.

Some Anomalies Due to Current Regulations

Consider alternative investments available to retail investors. A retail investor can take out a large loan and invest the loan monies in more risky shares or direct property but is prohibited from investing in wholesale, investment-grade corporate bonds. This is illogical, unreasonable and unfair!

Consider a SMSF that is a wholesale client and has invested in wholesale corporate bonds. As member accounts are drawn down in pension phase and assets of the fund fall below that which is currently

required to be a wholesale client, the SMSF now becomes a retail client and is not permitted to invest in wholesale corporate bonds! This is also illogical.

Now that ASIC (on 8th August 2014) has somewhat relaxed its definition on what constitutes a wholesale SMSF, it is unreasonable that not all SMSFs are able to access all wholesale financial products.

In principle, SMSFs are permitted to invest in any investable asset. Such assets can include, financial derivatives, gold bullion and collectibles and in any global market. But unless an SMSF is a wholesale investor, (of which the majority of SMSFs are not) they are not permitted to invest in wholesale corporate bonds. This is clearly an inconsistency in the legislation, which can and should be corrected by abolishing the legislative distinction between retail and wholesale investors.

Australian Security and Investment Commission's (ASIC) Information Sheet 99 states that a credit rating must not be disclosed in a manner that is intended to (or could reasonably be regarded as being intended to) influence a retail client in making a decision in relation to a particular financial product or class of financial products, but a credit rating can be provided to a wholesale investor. This requirement is an excessive and unreasonable level of consumer protection, particularly in relation to investment in corporate bonds. Surely a retail investor should be entitled to know, at the very minimum, whether a corporate bond is considered to be of investment grade! Furthermore it is reasonable to think that an investor will make an investment decision on more than just a credit rating of a fixed interest product. The requirement of ASIC's Information Sheet 99 should be abolished.

Conclusion

Already one submission to this Inquiry (by Wilson Asset Management) has called for all investors to be treated equally and equitably. I strongly support this view.

While it is never possible to legislate to protect the investing public against all risks, we are now in an era where much more company information and research on companies is readily available (most often free) via the internet, brokers and subscription financial information services. This allows investors to make much better and more informed investment decisions than in the past and hence reduces their investment risk.

With the SMSF segment now making up such a large portion of the total superannuation market, SMSFs, should not be prohibited from investing in wholesale corporate bonds. The fixed interest asset class is one of the less risky asset classes and should be available to all investors. Already, SMSFs are required to comply with the 'Prudent Person Regime', which helps minimize investment risk.

By removing the distinction between wholesale and retail investors also removes the requirement for financial advisors having to make this determination of a client and for the wholesale client having to prove, every two years by way of an accountant's certificate, that they are still a wholesale client. Potential confusion and some bureaucratic red tape would be eliminated.

At a time of low interest rates, many retail investors have been reported to be chasing income yield by investing in so-called 'high dividend' paying shares. They would be better served by being able to access the total market of corporate bonds.

It is recommended that the distinction between retail and wholesale investors as set out in Section 761G and 761GA of the Corporations Act 2001 (Cth) be abolished but that retail/consumer protection continues be applied to all investors except professional investors (fund managers, etc) or those who wish to opt out. The requirement of ASICs Information Sheet 99 should be abolished.

Yours sincerely,



Peter Hoffmann, PhD
RETIRED INVESTMENT ADVISOR