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Companies and Securities Advisory Committee

Commentary on CLERP Consultation Paper:  
Financial Products, Service Providers and  
Markets - An Integrated Framework

May 1999

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The Consultation Paper is a broad-ranging document which largely incorporates the recommendations in the Advisory Committee's Final Report on *Regulation of On-exchange and OTC Derivatives Markets* (June 1997) and the subsequent Advisory Committee *Commentary on CLERP Paper No 6* (February 1998). The Consultation Paper also states that consideration will be given to the recommendations in the Advisory Committee's *Report on Continuous Disclosure* (November 1996).

In this Commentary, the Advisory Committee raises two matters affecting retail participants where it disagrees with the proposals in the Consultation Paper, namely:

- “opting up” by retail clients
- the “time-critical transaction” exception to the “know your client” rule.

The Committee also refers to two other matters on which it recommends some amendment to the Consultation Paper proposals.

### **Retail clients' access to wholesale financial products - opting to be treated as wholesale**

The Advisory Committee supports the concept of flexibility in the regulatory regime for financial markets. However, it is concerned about the proposal to permit retail clients to elect to be treated as wholesale and directly participate in any wholesale-only market (the election proposal).

The Consultation Paper argues that the election proposal is necessary to provide retail participants with effective access to wholesale markets, which may otherwise be closed to them. The Advisory Committee considers that the most appropriate means for retail participants to access these markets, without forfeiting the protections designed for them in the Consultation Paper, is by investing in managed investment schemes which deal in those markets. This method of intermediated involvement permits retail end-users to obtain the benefits of wholesale-only markets, but without the risks that would arise from direct participation.

The Advisory Committee opposes the election proposal for other reasons, as outlined below.

- The election proposal would permit any retail participants, regardless of their level of sophistication or prior involvement in financial markets, to opt up. However, to introduce some additional sophistication or prior involvement restriction on opting up could be unduly complex. Alternatively, giving ASIC a discretion to permit only appropriate retail participants to opt up could create a potential “moral hazard” residual liability for ASIC and the Government. The Committee does not consider that ASIC should be required to act as arbiter of who can transact in wholesale-only markets.
- Retail participants who opt up would forfeit the substantial protections designed for them. This might eventually result in pressure to further regulate wholesale-only markets to better protect those participants.

- The scope and application of the unconscionable inducement prohibition are unclear. It does not indicate what behaviour it proscribes, and what, if any, obligations rest on a financial service provider dealing with a retail client at the time of that person's decision to opt up.
- It is also unclear how the proposed unconscionable inducement prohibition would be enforced. If it were intended to be a criminal sanction, it may be difficult to prove the necessary elements in particular cases. Alternatively, enforcement of that prohibition through licensing alone may not meet public expectations that retail participants who elect to be treated as wholesale are nevertheless adequately protected.
- The election proposal would appear to permit any retail participants to opt to be treated as wholesale for all their future transactions. This would raise the problem of whether, or in what circumstances, any financial service provider involved in the original election would bear any civil liability for those later transactions.

*Recommendation: The Committee recommends that the CLERP legislation not include the election proposal.*

### **“Know your client”**

The Advisory Committee supports the proposal that any financial service provider who provides personal advice to a retail client should be subject to a “know your client” rule.

However, the Consultation Paper contemplates an exception for “time-critical transactions”. The Paper proposes that a financial service provider who has been unable to conduct a needs assessment because of a time-critical transaction should be required to provide a warning in lieu.

The Advisory Committee understands that this proposed exception was primarily intended to deal with “execution-only” orders and various insurance contracts such as cover notes. The Committee considers that the “know your client” rule would not usually apply to execution-only transactions, given that they do not involve providing personal advice. Also, the CLERP legislation could deal specifically with insurance contracts.

The Committee opposes any broader introduction of a “time-critical transaction” exception for the following reasons.

- The proposed exception would permit a financial service provider to advise a retail client to enter into time-critical transactions before an assessment of the client's needs was undertaken or completed. These types of transactions do not give retail clients sufficient opportunity to consider their implications and may therefore be particularly detrimental to them.
- A time-critical exception could encourage “boiler room” and other forms of undesirable pressure selling to new retail clients, notwithstanding the

proposals in the Consultation Paper to control cold calling and other types of improper selling practices.

- A time-critical exception is unnecessary for transactions entered into after the initial needs assessment, provided that the CLERP legislation makes clear that any financial service providers who provide personal advice can continue to act on the basis of the information already given by their clients. Clients should have the obligation to notify their advisers of any new or changed information regarding their circumstances.

*Recommendation: The Committee recommends that any “time-critical transaction” exception be limited to various forms of insurance contract and (possibly) “execution-only” orders. The CLERP legislation should also make clear that any financial service provider who provides personal advice to a retail client may continue to act on the basis of information previously given by that client until changed by the client.*

### **Other matters**

The Advisory Committee also refers to two other matters which could be clarified in the CLERP legislation.

#### *Banning persons who deal on their own behalf*

The Consultation Paper proposes to exempt from licensing those persons who conduct a business of dealing solely on their own account on a financial market. The Paper does not appear to deal with Recommendation 15 of the Advisory Committee Derivatives Report that ASIC have a power to ban persons who behave improperly from dealing on a financial exchange as principals on their own account.

*Recommendation: The Advisory Committee recommends that ASIC be given a power to ban persons who behave improperly in conducting a business of dealing on a financial market on their own behalf.*

#### *Definition of derivative*

The Consultation Paper includes a definition of derivative. However, under that definition, the only options that are classified as derivatives are options over derivatives or securities. The Advisory Committee in Recommendation 4 of its Derivatives Report recommended that the following be classified as derivatives:

- all exchange-traded options (regardless of whether they are options over derivatives, securities or any other underlying, such as a commodity)
- any other category of option prescribed by regulation.

*Recommendation: The Advisory Committee recommends that the definition of derivative be extended to include all exchange-traded options and any prescribed options.*