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Manager
Financial Services Unit
Financial System Division
The Treasury
Langton Crescent
Parkes ACT 2600

By email: productregulation@treasury.gov.au

Dear Treasury,

AFA Submission: Design and Distribution Obligations and Product Intervention Power

The Association of Financial Advisers Limited (**AFA**) has served the financial advice industry for over 70 years. Our objective is to achieve *Great Advice for More Australians* and we do this through:

- advocating for appropriate policy settings for financial advice
- enforcing a Code of Ethical Conduct
- investing in consumer-based research
- developing professional development pathways for financial advisers
- connecting key stakeholders within the financial advice community
- educating consumers around the importance of financial advice

The Board of the AFA is elected by the Membership and all Directors are practicing financial advisers. This ensures that the policy positions taken by the AFA are framed with practical, workable outcomes in mind, but are also aligned to achieving our vision of having the quality of relationships shared between advisers and their clients understood and valued throughout society. This will play a vital role in helping Australians reach their potential through building, managing and protecting wealth.

Introduction

The AFA is broadly supportive of the Design and Distribution Obligations and Product Intervention Power legislation. It is our view that this legislation, on top of existing obligations may potentially have some impact in assisting clients to avoid losing money in investments that are not suitable for them. Whilst we are supportive of the Product Intervention Power for ASIC, as a reserve power, we do not actually believe that history would indicate that any of the product collapses might have been avoided if ASIC had a product intervention power at the time of the Global Financial Crisis.

We are concerned that the purpose of the legislation is not as well explained as might be possible. We have contemplated this legislation from the perspective of the avoidance of losses on higher risk investments, and therefore are surprised that the legislation will apply to virtually all financial products, including life insurance products. Whilst we are conscious that issues have emerged in the life insurance space, particularly with respect to the sale of add-on insurance products in car yards, we do not believe that this legislation is the best approach to deal with these issues. If products like MySuper and margin lending are excluded from the scope of this legislation then we see no reasons why Life Insurance is not treated in the same manner. We recommend that life insurance be removed from this legislation.

We question the intent to apply the provisions of this legislation to virtually all financial products. From our perspective it would seem to make greater sense and be more practical to limit the application of this legislation to higher risk investment products.

We note the explanation in paragraph 1.23 of the EM for the exclusion of ordinary shares and particularly the part about there being a level of understanding regarding such securities among consumers. If this was the case then we would assume that such an argument could equally apply to share funds that invest directly in ordinary shares. When it comes to consumer awareness, then we would assume that basic banking products would rate more highly than ordinary shares. This point also opens up further questions about direct shares held via a platform.

It is our view that the extensive scope of the legislation, in terms of products incorporated, impacts upon the clarity of the purpose of this legislation. Further clarification is required in a number of areas.

There is repeated use of the word 'significant' in the obligations, that is not adequately explained (i.e. significant dealings and significant detriment). Whilst this might be left to the regulations or ASIC regulatory guidance to clarify, we are of the view that it should be more clearly explained in either the legislation or the Explanatory Memorandum (EM).

We express concern about the impact of these measures on the cost of providing financial advice. This is particularly the case with respect to the record keeping obligations, but also more broadly in the additional actions that this legislation may require. We note that the Regulatory Impact statement suggests that this legislation will result in an increase of $239 million in annual operating costs across the industry. This is a very significant sum, however there is no breakdown of this within the EM in order for us to understand how much of this might be incurred by the financial advice sector. The cost increases from this legislation come on top of a number of other recent regulatory driven increases which will impact upon the cost of providing advice to Australian consumers and will therefore negatively influence access to financial advice for average Australians.

Design Obligations

Obligation to Make a Target Market Determination

The AFA, in principle, supports the introduction of an obligation for product issuers to identify the target market that is suitable for their products. We believe that this will have benefits for products that are either complex or high risk. With simple products that have broad client application, we anticipate that the benefits will be very limited for consumers.

We are concerned that the draft legislation and the EM fail to provide adequate explanation of what a Target Market Determination is and as a result there will be a lack of consistency across the market, with reduced benefits to consumers. The legislation states that the product issuer needs to describe the class of person who comprise the target market for the product. When it comes to investment products, this exercise needs to be viewed in terms of the proportion of the portfolio that might be invested in the product. Whilst it may not be suitable for an older client to invest 50% of their portfolio in a higher risk product, it might be more suitable if the investment allocation is restricted to 5% – 10%. The appropriateness of a product may vary depending upon the asset allocation decision.

It is noted that this exercise is assumed to be based upon demographic data and not the specific client's risk profile, however this assumes that everyone within a demographic group are of similar circumstances and needs. This is simply not the case. Some people, from the same demographic group, are much more willing to take risks than others. Paragraph 1.40 of the EM implies that product issuers will have an understanding of consumer groups to a level well above what is practical to attribute to a demographic group.

What are the implications of a knowledgeable client actively choosing to invest in a product where they are not in the target market? Should a financial adviser discourage them from doing so, or simply note the reasons and circumstances and then prepare the records to include this as a client invested in a manner that is inconsistent with the target market determination?

The AFA believes that the Target Market Determination should be set out in Product Disclosure Statements (PDSs) and Prospectuses. It is our view that this is information that is useful for clients and that they should participate in the process of deciding whether the product is suitable for them. This is particularly the case with clients who purchase investment products directly. It is noted that it needs to be including or referred to in advertising, so it should also be included in PDSs. We do not consider it satisfactory for clients to be referred to another location to consider whether they are part of the Target Market Determination.

Obligation to Review a Target Market Determination

The AFA supports the requirement to review Target Market Determinations over time. This is eminently sensible as some key factors may change over time. We note that review triggers need to be defined at the time the Target Market Determination is made and that a timeframe for review also needs to be established. We note the explanation on review triggers in paragraph 1.46, however feel that further guidance is required. The same applies with respect to the timeframe for review, which we assume will be addressed in ASIC regulatory guidance. What is a reasonable review timeframe for a high risk product?

It should be noted that consumer risk tolerances often change at times of major market declines. We do not feel that a significant fall in the share market should be the basis to fundamentally reassess the appropriateness of a product for the target market. We would suggest that review triggers should be based upon a change in the underlying investment option, and not a change in the market direction or economy.

Record Keeping Obligation

The AFA supports the proposal with respect to record keeping obligations for product issuers. These obligations seem sensible and achievable. As discussed below, the record keeping obligations for distributors are significantly greater and substantially more expensive to implement and maintain.

We question whether the draft legislation and the EM adequately express the obligations for record keeping when undertaking a review of the Target Market Determination in the context where the decision is that no change is required.

Obligation to Notify ASIC of Significant Dealings that are not Consistent with a Product's Target Market Determination

Whilst the AFA is supportive of this requirement, we are of the view that there is a complete lack of clarity of what "significant dealings" may involve. Does this need to be assessed in terms of the number of clients or the dollars involved. We question this in the context of the discussion above about a client who is determined to invest in a particular product when they are not in the Target Market Determination. We expect that this will happen from time to time, however cannot see any value in such a situation being reported to ASIC.

Greater clarification is required in either the legislation or the EM for what "significant dealings" means.

Distribution Obligations

We note that the distribution obligations apply to regulated persons, which includes AFSLs and Authorised Representatives. This means that the obligations don't apply directly to representatives who are employees or directors of an AFSL. Whilst this is broadly consistent with much of the Corporations Act, we do note that the Future of Financial Advice legislation extended some obligations, such as the Best Interests Duty to representatives via reference to the concept of 'providers' (Section 961).

Obligation not to Deal or Advise Unless a Target Market Determination has been Made

The AFA is supportive of the requirement to not deal or advise on a product when a Target Market Determination has not been made.

In the financial advice space, as AFSL's need to go through a formal process before products are added to an Approved Product List, it is obvious that products will not be on the list until a Target Market Determination has been made. It is anticipated that when the regime initially commences that this will place a lot of pressure on the product approval process, however on an ongoing basis it should be more manageable.

From the perspective of an adviser authorised by an AFSL to provide personal advice, it would be beneficial for the adviser to have visibility of the Target Market Determination, which supports our previous statement that it should be included in the PDS. Issuers need to ensure that both AFSLs and their representatives have access to this information.

As a distributor, an adviser will also want to be confident that a Target Market Determination review has been undertaken within the required timeframe. For this reason, the timeline for a review would need to either be on the public record or be communicated to the AFSLs and advisers who are using those products.

Obligation not to Distribute Where a Target Market Determination may not be Appropriate

We note the discussion in the EM (paragraph 1.61 – 1.63), which suggests that this is an obligation that applies to issuers. We note that some issuers will also be distributors, however we question why this obligation is listed as a distributor obligation.

We envisage that financial advisers will not be aware that a trigger event has occurred or that some other event has occurred that might suggest that the determination is no longer appropriate. We expect that there would be restrictions on issuers disclosing this potentially sensitive information directly to advisers.

We believe that this obligation needs to be reclassified as an issuer obligation or that greater clarity is required.

Obligation to take Reasonable Steps to Ensure Compliance with a Target Market Determination

Whilst we agree, in principle, that an adviser should take reasonable steps to ensure compliance with a Target Market Determination, we also recognise that in some circumstances that a client may insist on investing in the product, despite the fact that they are aware that they are not in the target market for that product. Otherwise an adviser may form an opinion that recommending the product is in the best interests of the client, despite the fact that the client is not included within the target market for that product. As an example, they may already have an existing investment in that product and wish to continue investing in the product. This would be very difficult for the financial adviser where, based upon their detailed understanding of the client and the product, they might assess the product as appropriate for the client, despite the fact that they know the client is not in the stated target market. There would seem to be a risk that this was a breach of Section 993DE(2). It is not entirely clear whether this would be a breach of the reasonable steps requirement, however we would prefer to see that this scenario is taken into account.

For the reasons discussed above, acting in the client's best interest may conflict with the target market obligations, which would place an adviser in an extremely difficult position.

We believe that the legislation needs to identify dealing on a product for a client that is not in the target market as a possibility and provide greater clarity in terms of what the adviser was expected to do.

Obligation to Collect Distribution Information

We question the intent of the obligation to collect distribution information. These obligations will apply to financial advisers who already have obligations to document their advice, including through the preparation of Statements of Advice. These advice documents and related client files will articulate the dollar value of each product recommended by the adviser, the circumstances with respect to which the advice was provided and why the product is suitable to the client. If this information was recorded as part of the preparation of a Statements of Advice, then we are unlikely to have any particular concern, however paragraph 1.69 of the Explanatory Memorandum appears to imply that financial advisers would need to maintain an active consolidated record of all clients in each applicable financial product.

What is proposed is simply not practical. Whilst some advisers may have a system for understanding on a consolidated basis the investment holdings of each client, this is certainly not universal and such systems are often not 100% reliable. This is further complicated by the proposal to include life insurance products in this regime, when they are often on separate systems.

Many advisers rely upon product provider systems for such information, however they often use multiple platforms and product provider systems and therefore the information is contained in multiple systems and is never actually consolidated into the one system. Some of the financial planning software solutions enable the consolidation of client information, however this is dependent upon the data feeds for all product providers being set up correctly and for each client to be set up correctly. It is also the case that some clients might hold products, which they want their adviser to have oversight on, but where the adviser is not recorded with the product provider as the adviser. As an example, many industry superannuation funds do not enable a financial adviser to be recorded and they will not have on-line visibility of the product holding. There is no automated solution for such a situation. Where the typical adviser has over 250 clients and uses multiple platforms and investment options, this becomes a particularly complex proposition.

We would also like to raise the issue of how this obligation might apply in the context of advice that involves ongoing superannuation and investment contributions. This could be either via a recommendation to invest on an ongoing basis in a superannuation fund or a regular investment plan in a managed investment scheme. Does the adviser have an obligation to keep records of all individual investments, or just the initial investment? In addition, what are the implications if the client has investments in a product some of which is pre-commencement and some is a post-commencement investments. The client may have made withdrawals that might need to be applied either against the pre-commencement or the post commencement balance. This can be very complex. Needing to separately track individual components would be extremely expensive to try to build and impossible to do accurately.

The AFA believes that it should be sufficient to record details on the client file with respect to the consideration of these target market obligations and that any requirement to develop and maintain records of consolidated product holdings should be removed from the legislation and EM.

Obligation to Notify Issuer of Significant Dealings that are not Consistent with a Product's Target Market Determination

Whilst the AFA is supportive of this requirement where it reflects unintended dealings in a product for a client that was not in the target market, however we do not think that it should be required where the adviser has considered the issue and made the determination that the product is appropriate for the client. We are however of the view that there is a complete lack of clarity of what "significant dealings" may involve. Does this need to be assessed in terms of the number of clients or the dollars involved? Is it based upon a large number of clients or a client with a large investment balance?

Greater clarification is required in either the legislation or the EM for what "significant dealings" involves.

Promotional Material Must Refer to the Target Market

The AFA supports the requirement to refer to the target market in any advertising, however believes that the Target Market Determination should be set out in the PDS so that the client does not need to look in one place for the PDS and another place for the Target Market Determination.

ASIC Powers and Associated Matters

Whilst we are broadly supportive of the proposed powers for ASIC, this is subject to our concerns expressed above with respect to the record keeping obligations for distributors.

Information Gathering Powers

Whilst we recognise the need for ASIC to have information gathering powers, we refer to our feedback above on the impractical nature of the record keeping obligations for distributors. It would be extremely difficult for AFSLs and advisers to comply with these obligations and impossible for them to do it in the timeframe proposed.

Stop Order Power

The AFA supports the stop order power.

Exemption and Modification Powers

The AFA supports exemption and modification powers for ASIC.

Consequences of Breaching the New Provisions

We note the statement that the penalties applicable to each obligation are broadly consistent with current penalties applicable to comparable provisions in the Corporations Act. We question this as the penalties proposed in this legislation are both criminal and civil. This is in contrast to the Financial Services Reform Act penalties that are largely criminal and the Future of Financial Advice Act reforms that are largely civil.

As discussed above with respect to record keeping, we have major concerns about the ability for financial advisers to comply with these requirements and we therefore oppose the scale of penalties proposed for failing to collect and keep distribution information. We also question the penalty for failing to notify an issuer of significant distributions (dealing) that are not consistent with a products target market determination, when there is a lack of clarity on what a significant dealing is.

As discussed above we believe that there are likely to be grounds for dealing or advising on a product for a client who is not in the target market and therefore we have concerns about the consequences for "failing to take reasonable steps to comply with a target market determination". We ask that this matter be reviewed.

With respect to the civil liability provisions and the scenario raised above with respect to a product that the adviser may conclude is appropriate for the client, however the client is not in the target market, we would like to see greater clarity that this would be excluded from the civil liability provisions. We would prefer that this was explicitly stated.

Such matters could also be considered by External Dispute Resolution schemes and it is important that the implications for them have been considered.

Application and Transitional Provisions

The AFA is supportive of the transitional provisions, but notes that this will involve a great level of work at both the product issuer and the distributor/adviser end when the new regime first commences. We would like to think that solutions to streamline this process can be found.

12 months for new products and 24 months for existing products appears reasonable, provided that any regulations and regulatory guidance can be delivered quickly. It is assumed that Target Market Determinations can be developed and issued to product distributors and financial advisers well in advance of the commencement date, so that they can be reviewed and product approval processes completed in a timely manner.

Financial advisers have clients who are making ongoing superannuation and investment contributions on the basis of previously provided financial advice. This might be for ongoing employer and personal contributions into a choice superannuation fund or as part of a regular investment savings plan. The EM and the legislation does not address the obligation that would apply to these advisers for these ongoing investment clients when the legislation becomes effective (at 24 months). Are they required to identify each of these ongoing investment clients and undertake a Target Market Determination prior to any additional contributions being made? Does a similar obligation apply with respect to future premiums for life insurance products?

Product Intervention Power

Intervention Orders

The AFA is broadly supportive of the intervention powers as proposed.

We believe that paragraph 2.11 of the EM suggests that intervention orders will not be enacted on any product that is in existence prior to the commencement of the legislation. This is not reflected in the legislation and therefore either the EM or the legislation needs to be changed. We can see arguments for making this applicable to new products only or having it apply to any open product. Either way, the EM needs to clearly set out the position and explain the rationale for it.

We question the circumstances where ASIC has issued an intervention order and requires persons who have dealt in or provided financial advice with respect to the product to notify the clients. It is our view that the product issuer should have this obligation. The person who dealt in the product or advised on the product may no longer be in business or may no longer have the contact details of the clients. Another adviser may have purchased that business or book of clients.

The product issuer should have the contact details and should be primarily responsible for communicating with the client. We would also suggest that the product issuer will have access to better information on the intervention order and the issues behind the order, that would be necessary to frame the communication. We recommend that this element of the legislation be modified to remove the potential obligation for the adviser to communicate with the client on an intervention order.

Consequences of Contravening the New Power

As discussed above we do not agree that a person who dealt in a product or advised on the product should have responsibility for communicating with clients as a result of an intervention order. We therefore oppose the penalty for "failure to notify consumers of the intervention order" applying to financial advisers.

Regulation Impact Statement

Our feedback on the Regulation Impact Statement is as follows:

- All the product collapse examples used are either GFC or pre GFC. Matters such as Storm Financial, Opes Prime, Westpoint, agribusiness schemes, unlisted debentures and mortgage funds did result in significant losses for consumers, however it is not apparent that these product intervention powers would have enabled these losses to be avoided. One example that is discussed is the mortgage funds that were frozen during the GFC. This happened very shortly after and most probably as a result of the Government putting in place the bank guarantee. There would not have been enough time to act and the outcome would not have changed as a result. We need to be careful in assessing product collapses with the benefit of hindsight and assuming that something different might have been done in the lead up to the collapse. This is exactly why it is called hindsight. Thus it is important for the Australian population to understand that these new powers will not prevent collapses in the future.
- We take exception to the statements made in paragraph 3.13, and particularly "Despite efforts over many years, the financial advice industry failed to improve financial advisers' conduct leaving it unable to prevent or reduce the effect of recent serious cases of poor advice". The examples that are referred to in this section are all at least seven years ago and we also believe that this comment downplays the significance of the reforms that have been implemented

since the GFC. It should also be noted that with the exception of Storm Financial, the other matters were predominantly product collapses.

- Given the scale of the estimated cost of the design and distribution obligation regime ($232.1 million) and the product intervention regime ($7.7 million), we believe that the Regulation Impact Statement should set out the breakdown of this in more detail to assist the industry to understand the consequences. This is expressed as an annual compliance cost, however there is no reference to initial implementation costs, which should be shown separately. This appears to be a very superficial exercise for what is obviously a very substantial commitment and cost for industry. Surprisingly there is no reference to the expected financial benefit from the legislation.

Concluding Remarks

The AFA is broadly supportive of the introduction of these new obligations and powers, however we do have particularly concerns as raised above and ask Treasury and the Government to take these into account in finalising the legislation and the EM.

The AFA welcomes further consultation with Treasury should it require clarification of anything in this submission. If required, please contact us on [redacted].

Yours faithfully,

Philip Kewin
Chief Executive Officer
Association of Financial Advisers Ltd