ASIC

Australian Securities & Investments Commission

Design and distribution obligations and product intervention power—Exposure draft legislation

Submission by the Australian Securities and Investments Commission

February 2018

Contents

Overview

1 The Australian Securities and Investments Commission (ASIC) welcomes the Government's release of the exposure draft of the Treasury Laws Amendment (Design and Distribution Obligations and Product Intervention Powers) Bill 2018 (exposure draft legislation). We support the Government's commitment to creating new design and distribution obligations in relation to financial products, and to strengthening consumer protection by introducing a product intervention power for ASIC.

2 Both reforms represent a fundamental shift away from relying as predominantly on disclosure to drive good consumer outcomes, and are central to realising the Financial System Inquiry's (FSI) vision of promoting consumer trust in the system and fair treatment of consumers.

Design and distribution obligations

3 We support and are committed to implementing the new design and distribution obligations in relation to financial products created by the exposure draft legislation, and welcome their broad coverage across products that are both relatively simple and more complex.

4 These obligations will overcome gaps in the current regulatory regime across the lifecycle of financial products and promote better, fairer outcomes for consumers by encouraging:

(a) financial products that are appropriately designed for the consumers for whom they are intended;

(b) distribution processes and controls that reduce the chance that products will be issued to consumers for whose objectives, financial situations and needs they are not appropriate; and

(c) a dynamic and responsive process where product design and distribution is reviewed and improved in response to feedback and experience.

5 We expect that the obligations would formalise what consumers already expect a well-run financial services business, focussed on treating its customers well, would already do, such as:

(a) having in place appropriate processes and control around product approval and development;

(b) thinking the distribution channels it develops or selects ensure that products are directed at the appropriate target market, and avoid significant sales outside of that target market;

(c) ensuring that there are clear communications between issuer and distributor; and

(d) having in place systems to support ongoing record-keeping and monitoring of compliance with processes and controls, as well as the monitoring of outcomes for consumers for whom the product is intended (as a cohort), and any signs of problems being experienced.

6 We note that the FSI specifically considered imposing an individual suitability assessment, but ultimately did not recommend that approach.[1] We therefore anticipate that ASIC's surveillance and enforcement work in relation to these obligations would focus on ensuring that businesses have effective product governance processes and controls in place to ensure that any product they issue is appropriate for the class of persons at which it is aimed (the target market), and that these processes and controls are being properly followed.

7 To support industry's implementation of design and distribution obligations, ASIC will provide regulatory guidance. We intend to undertake consultation on this as soon as possible after legislation is passed by Parliament.

8 We support the design and distribution obligations applying as broadly as possible. As currently proposed, the design and distribution obligations would not apply to products regulated under the *National Consumer Credit Act 2010* (National Credit Act) or the *Australian Securities and Investments Commission Act 2001* (ASIC Act). As discussed in Section A, we think that there are strong policy grounds for applying design and distribution obligations to these products, too.

Product intervention power

9 The introduction of a product intervention power will better equip us to respond to market problems that are causing or could cause harm to consumers.

10 Providing ASIC with a product intervention power will not mean we can prevent all losses. The product intervention power is not a prudential tool, and will not necessarily prevent product failures or collapses, and there will still be risk in the financial markets.

11 However, the power will assist ASIC to reduce the number of people for which the risks of a product are misaligned with their financial situation, objectives and needs, or that they are at least aware of the risks and take

[1] The Australian Government the Treasury, *Financial System Inquiry Final Report* (PDF 4.8 MB), report, 7 December 2014, pp. 201–205.

them on in an informed manner. The power will provide us with a more timely and responsive regulatory tool than relying on legislation alone to address gaps in the current law.

12 We envisage that:

(a) we would generally only use the product intervention power after a significant process of evidence gathering and consultation;

(b) we would look for interventions that represented the most targeted and appropriate regulatory solutions to address a market problem that we had identified;

(c) our interventions would generally be relatively low in intensity—or we would only use more interventionist measures if low-intensity interventions had not or would not address the particular market problem;

(d) given the flexible nature of the power, we could withdraw an intervention if the problem had been resolved or if the intervention were not effective; and

(e) the consultation process we would undertake with industry before imposing an intervention could potentially be a catalyst for industry to develop its own solution to the market problem we had identified, alleviating the need for formal intervention.

13 The product design and distribution obligation and product intervention power will work together in the interests of consumers. If the design and distribution obligation is being complied with, there will be less need for ASIC to exercise the intervention power.

14 We note that the product intervention power will be introduced with rigorous procedural and accountability requirements for ASIC, including requirements around consultation and the release of a statement by ASIC setting out, among other things, why the order is an appropriate way of reducing significant consumer detriment. To provide greater transparency, we will undertake consultation on our approach to using the product intervention power after legislation is passed by the Parliament.

15 Under the current approach taken in the exposure draft legislation, there are some limitations on the types of interventions that ASIC would be able to make, and the range of products that could be subject to an intervention. In particular, ASIC would not be able to make interventions relating to credit and financial products that are not regulated under the National Credit Act or the Corporations Act, but under the ASIC Act. This latter group includes some products that are functionally equivalent to products regulated under the National Credit Act and Corporations Act. A product intervention power that is as broad and as flexible as possible would permit ASIC to develop measured, comprehensive and appropriate regulatory solutions to address the

range of market problems we see. If the product intervention power is not sufficiently broad, this risk expectations about our ability to use the power to address market problems not being met.

About this submission

16 ASIC welcomes the opportunity to comment on the exposure draft legislation and provide input into its development.

17 Our submission sets out observations and issues for consideration about both the product intervention power and the design and distribution obligations:

(a) Section A expresses support for the proposed broad coverage of the design and distribution obligations, but proposes that the obligations could be applied to a broader range of products, including credit products. It also comments on other aspects of the exposure draft legislation, including its objects clause and enforcement mechanisms and penalties.

(b) Section B outlines support for a product intervention power that:

  (i) covers the full range of financial products and credit products that are accessed by consumers, within ASIC's regulatory remit (including products regulated under the ASIC Act, such as funeral insurance and warranties);

  (ii) can be used to make interventions relating to all circumstances in which a product is distributed, including improving the training of those involved in distribution where appropriate; and

  (iii) is accompanied by appropriate enforcement mechanisms and penalties (in some cases higher than proposed).

A Design and distribution obligations

Key points

We welcome exposure draft legislation to introduce design and distribution obligations that require issuers and distributors to establish processes and controls for ensuring that products are designed with consumer needs and understanding in mind and are targeted appropriately.

We support the proposed approach in applying design and distribution obligations across most financial products, with a few limited exceptions. We think the obligations should also extend to products regulated under the National Credit Act and ASIC Act.

It may also be useful to consider whether the exposure draft legislation objects clause could better describe the aims of the reforms.

The success of the reforms will also depend on having appropriate enforcement mechanisms and penalties in place.

18 We welcome the Government's consultation on exposure draft legislation to introduce design and distribution obligations in relation to financial products. The obligations will require issuers and distributors to put in place (and follow) appropriate product governance processes and controls. They should therefore operate as a framework to ensure a fair, foundation level of consumer protection, including that products are well designed and distributed to meet consumers' objectives, financial situations and needs.

19 We are very supportive of these obligations and we consider that they have the potential to significantly improve consumer outcomes. However the ultimate success of these obligations will depend on:

(a) how widely these obligations will apply; and

(b) the enforcement mechanisms and penalties associated with non-compliance.

20 This section outlines why we support the approach taken in the exposure draft legislation, in applying the design and distribution obligations across as wide a range of financial products as possible, with the starting point that the obligations should apply to all financial products made available to retail clients under the Corporations Act with some exceptions (e.g. ordinary shares).

21 It also outlines our view that the design and distribution obligations should be extended to apply to all financial and credit products regulated under the National Credit Act and ASIC Act to comprehensively address gaps in the

current regulatory regime and to avoid potential regulatory arbitrage in issuers choosing to issue financial products that:

(a) are regulated by ASIC under the ASIC Act; and

(b) are functionally equivalent to products regulated under the Corporations Act, but technically exempted from regulation under that legislation; and

(c) would therefore not be subject to the design and distribution obligations.

22 Finally, this section also sets out our view that enforcement mechanisms and penalties should ultimately reflect the recommendations of the ASIC Enforcement Review Taskforce, but may, in some cases, need to be increased.

Scope of the design and distribution obligations: Support for a broad and comprehensive approach

23 Through our regulatory work, ASIC has identified specific consumer issues that are currently not well addressed due to gaps in the current regulatory regime. These issues include:

(a) products that are not well designed to provide utility (e.g. value for money) to many types of consumers;

(b) products that are only likely to be suitable for a limited class of consumers, but are distributed without appropriate targeting, making it likely that they will ultimately be sold well beyond the class of consumers for which they are suitable; and

(c) instances where the volume and types of complaints entities are receiving suggest the distribution process is not working effectively, but no action is taken.

24 It has been recognised for some time that disclosure alone is not working to drive fair consumer outcomes—for example, disclosure alone is unlikely to correct the effect of broader market structures and conflicts that drive product development or distribution practices that result in poor investor outcomes.

25 Additionally, while the 2012 Future of financial advice (FOFA) reforms have achieved significant changes in the advice area, regulation around the design and distribution phases (unless advice is provided) is not subject to similarly focussed regulation. This is despite the fact that there are many products that are distributed without advice and that the quality of the design and distribution phases also independently impacts outcomes for consumers, whether or not advice is provided.

26 The missing element has been regulation designed to improve the fairness of the design and distribution process.

27 In identifying this, the FSI recommended that product issuers and distributors take greater responsibility for the design and targeted distribution of products to promote positive consumer outcomes:

> Currently, in seeking to align commercial incentives with consumer outcomes, the regulatory framework is focused on point of sale. Recent examples of poor conduct suggest the alignment needs to start at the point of product design, and then be strengthened through distribution and advice.[2]

28 Noting the range of problems that had been seen across different types of products, the FSI's model was for scalable obligations that would apply broadly, to both relatively simple and more complex products. We support this, and welcome the fact that this approach has been taken in the exposure draft legislation.

29 While we support the broad coverage proposed for the design and distribution obligations, we acknowledge that, given the range of products covered, this may raise a variety of different compliance issues for particular issuers or distributors. We will work with the Treasury to understand feedback provided to it as part consultation on the exposure draft legislation, and with industry when developing ASIC's guidance on how to comply with the obligations.

30 We have identified mis-selling and distribution problems across the spectrum of financial products. Even products with relatively limited features that may be described as 'simple' can be sold to a consumer, despite that product not meeting the consumer's needs, financial situation or objectives.

31 As outlined in the examples below, even at the relatively simple end of the spectrum, there is some variation in the features and conditions that attach to basic banking products—such that not all basic banking products will meet the needs of all consumers.

Example 1: Applying design and distribution obligations to basic banking products

Transaction accounts

Banks may offer both basic and fully featured transaction accounts, with differing fee levels. Due to their needs, financial situation or objectives, a

[2] The Australian Government the Treasury, *Financial System Inquiry Final Report* (PDF 4.8 MB), report, 7 December 2014, p. 193.

consumer may not require a fully-featured transaction account. Yet if they are sold this product, they may be paying ongoing fees to retain those features.

Banks may offer basic deposit products designed to meet the needs of vulnerable consumers. Yet if these products do not reach their target market, these consumers will not receive the benefits of these products and may select or be sold a product which is less appropriate to meet their needs. A framework around the distribution of these products could assist in preventing these issues and ensure that consumers receive products that better meet their needs, objectives and financial situation.

Similarly, some products may provide a better return if certain conditions are met, for example depositing a minimum amount each month. Targeting the marketing for those products should account for the fact that consumers who have no prospect of having the financial resources to meet such conditions will not benefit—and indeed may suffer a detriment—from taking out that product rather than another simpler product.

Term deposits

Our reviews of term deposits in 2010 and 2013, found that authorised deposit-taking institutions (ADIs) promoted their term deposits by advertising the high rates available on a limited number of term deposit periods, while maintaining significantly lower rates for all other deposit periods ('dual pricing'). This resulted in many customers receiving significantly lower rates if they stayed with their provider through automatic rollover of their deposit: see Report 185 *Review of term deposits* (REP 185), February 2010, and ASIC Report 353 *Further review of term deposits* (REP 353), July 2013.

While ASIC has taken action to address this issue, the example demonstrates that mis-selling can occur even with the most simple of financial products. Targeted distribution can assist in addressing this issue by ensuring that, for example, term deposits that have terms better suited to those prepared for an active investment are targeted to those consumers.

Additionally, the term deposits experience indicates the importance of product issuers monitoring and adjusting their marketing in response to high volumes of consistent customer complaints. At the time, complaints should have made it clear to term deposit issuers that there was a misalignment between:

- customer expectations (of a product that would over time produce reasonable returns consistent with the overall cost of funds, and which did not require active management): and
- the product actually received (where rates changed dramatically, unrelated to the cost of funds or economic fundamentals and where very close active management of the product was required).

However in the absence of design and distribution obligations, there was no positive obligation on issuers to monitor complaints or adjust their marketing.

32 Similarly, in the area of insurance, consumer outcomes would be significantly improved with the introduction of an obligation requiring product issuers and distributors to consider the particular needs of the target market for different forms of insurance (that is, appropriate cover), and the distribution strategies needed to ensure this works effectively.

Example 2: Distribution practices in home insurance

In our 2014 Report 415 *Review of the sale of home insurance* (REP 415) we noted that, while all insurers we surveyed provided consumers with comprehensive information and disclosure for home insurance products (mainly through their websites and within formal disclosure), many consumers may not have read these disclosures and, even when they had, they may not have always attained a complete and accurate understanding of the scope of the insurance.

We found that some elements of the distribution process could be improved to better assist consumers to select the right product and level of cover, and made a number of good practice observations on how this might be achieved. Having design and distribution obligations in place, including requirements to take reasonable steps to ensure distribution is undertaken in accordance with a product's target market determination, might have helped address some of these issues.

33 As outlined below in Example 6, ASIC has undertaken significant work in the area of add-on insurance. In this area, having design and distribution obligations in place could encourage positive change to practices on a more comprehensive basis.

34 In recommending the inclusion of simpler products like basic banking products, the FSI noted that compliance with the obligations would likely be relatively straightforward, where products are likely to be suitable for most consumers. While the FSI noted that simple, low-risk products such as basic banking products would not require extensive consideration and could be treated as a class, with a standard approach to their design and distribution, it still emphasised that the obligations should be universal and scalable. In our view, requiring issuers and distributors to turn their mind to the appropriate design and distribution of products is appropriate even where the products in question are relatively simple.

35 While complexity can be a relative concept where financial products are concerned, we have identified product structures and features that are inherently more likely to make a product complex. Our Report 384 *Regulating complex products* (REP 384) outlined some of these products. Complexity in products is significant because it may increase the likelihood that investors misunderstand the nature of a product and its risks. As we outlined in paragraph 3 of REP 384:

This can lead to an investor acquiring a product that is not aligned with the level of risk that they are willing to tolerate, which can in turn have a negative impact on investor confidence if unexpected loss occurs.

36 More complex products are also more difficult to describe in a clear, concise and effective manner in disclosure documents. Further, if inappropriate distribution channels are used for offering complex products to investors, this can increase the risk of mis-selling. Accordingly it is important that product issuers and distributors effectively manage these risks to reduce the likelihood of mis-selling. We think design and distribution obligations are an effective way of managing these risks and improving consumer outcomes. This view has been particularly informed by our work on hybrid securities, set out in the example below.

Example 3: Hybrid securities

Hybrid securities are known by a variety of names, including subordinated notes, capital notes and convertible preference shares. These products combine 'equity-like' and 'debt-like' characteristics and the nature and the risks of these securities can be difficult for investors to understand.

ASIC's Report 365 *Hybrid securities* (REP 365) noted the popularity of hybrid securities with retail investors, which is likely driven by:

- a general search for yield in a low-rate environment;
- the fact that the securities are issued by major banks and other corporate entities that are household names with trusted brands;
- the appetite of retail investors for investment alternatives, based on dissatisfaction with the returns on term deposits combined with distrust of equities, infrastructure funds, money market funds and debentures; and
- the promotion of offers of hybrid securities by brokers and financial advisers.

ASIC's Report 427 *Investing in hybrid securities: Expectations based on behavioural economics* (REP 427) provided further insight into investor decision making when investing in hybrid securities. In particular this report found that participants who were subject to an 'illusion of control' or 'overconfidence' bias relatively increased their hybrid allocation in a mock portfolio.

However the terms of hybrid securities are often very complex and many involve heightened risks for retail investors, such as risks deriving from long maturities and more complex features such as interest deferral or potential conversion into ordinary shares. For example hybrid investment features and returns often depend on whether or not a certain 'trigger event' occurs. A trigger event may be a loss of earnings causing the deferral of interest payments. If such an event occurs, a consumer may be left in the position where their interest payments are deferred for several years and their capital is not repaid for decades. This can have a significant impact on a

> consumer's financial situation, particularly if they were not aware of this risk.
>
> We think that the risks associated with hybrid securities may be exacerbated by their distribution. REP 365 noted that the sales process for hybrid securities is heavily intermediated, with offers distributed through networks of wealth management, private banking, stockbroking and financial advisory firms. Investors are also provided with a range of non-prospectus sales documents prepared by these firms, which may contain information which is in addition to, or inconsistent with, information in the prospectus.
>
> As noted in REP 365, the 'failure' of a number of hybrid securities issued between 2005 and 2007 which have operated according to their terms, but have nonetheless failed to meet the expectations of investors—suggests that many investors did not fully understand the features of these securities and the risks involved when they invested.

37 While we have worked with issuers to improve disclosure and distribution, as well as provided warnings to investors in relation to these products, we think that issuers and distributors need to take greater responsibility around the distribution of these products to ensure that these products generally meet the objectives, financial situation and needs of consumers at whom they are targeted.

Scope of the design and distribution obligations: Extending product coverage

38 Under the framework established by the exposure draft legislation, the design and distribution obligations would generally apply to financial products made available to retail clients under the Corporations Act with some exceptions (e.g. ordinary shares). As currently proposed, the obligations would *not* apply to:

(a) credit products issued under the National Credit Act; or

(b) credit and financial products that do not fall within either the Corporations Act or the National Credit Act, but are regulated by ASIC under the ASIC Act (e.g. some warranties and funeral expenses policies).

39 We support extending the design and distribution obligations to the broadest range of credit and financial products possible.

National Credit Act products

40 The Exposure Draft Explanatory Memorandum explains that the reason for not applying the design and distribution obligations to credit products

regulated under the National Credit Act is that such products are already subject to specific rules such as the responsible lending obligations.[3]

41 While the National Credit Act does set responsible lending obligations and other consumer protections, these are not equivalent to, or an adequate substitute for, the proposed design and distribution obligations.

42 As noted in paragraph 18, the new obligations provide a foundational framework for ensuring that firms have appropriate product governance processes and controls. On the other hand, responsible lending obligations are directed at individual transactions, and do not expressly require credit providers to:

(a) identify appropriate target and non-target markets for their products, taking into account whether a product is likely to meet the objectives, financial situations and needs of persons within the target market;

(b) select distribution channels that are likely to result in products being marketed to the identified target market; and

(c) periodically review products to ensure that the identified target market and the selected distribution channel continue to be appropriate for the product.

43 Thus, the responsible lending requirements—while serving an important regulatory purpose of reducing the potential for individual consumers to suffer hardship as a result of irresponsible lending—do not establish the same kind of underlying framework for ensuring that products are well designed and distributed to meet consumers' objectives, financial situations and needs as the design and distribution obligations.

44 Though complementary with responsible lending, the specific role that would be performed by the design and distribution obligations includes requiring issuers and distributors to:

(a) analyse the need of consumers within the target market for the product in a broader context than under the responsible lending obligations;

(b) consider the impact of all product features on the product's target market, including those that may be outside the scope of the responsible lending obligations; and

(c) monitor whether, at a broad level, consumers are getting an appropriate product (e.g. through feedback such as volumes and types of complaints).

45 The design and distribution obligations apply to the entire product lifecycle, including product design and development, when developing marketing and

[3] Draft Explanatory Memorandum, p. 10.

distribution strategies and post-sale conduct, including reviews. We think the design and distribution obligations would build on the current credit regime as follows:

(a) In the product design and development phase, lenders would need to turn their mind to the products they are developing, their features and costs, and the types of consumers for whom the product would generally meet the likely objectives, financial situations and needs—for example, whether the product is more appropriate for a consumer looking for long- or short-term credit, or with fewer or multiple existing loans. There are no parallel obligations in the current credit regime.

(b) In marketing and selecting distribution channels for products, lenders would need to ensure that they take reasonable steps to ensure that this is not inconsistent with the target market for the product—for example, that distribution of high-cost or complex credit or leasing products is not aimed at financially vulnerable consumers, or that marketing of interest-only loans is not aimed at first home buyers looking for an owner-occupied property. There are no parallel obligations in the current credit regime.

(c) At or near the point of sale, we think that there would be synergies between the new distribution obligations for product distributors and the responsible lending requirements. In particular these would arise in relation to the existing requirements to:

    (i) make reasonable inquiries about a particular consumer’s financial situation and the consumer’s requirements and objectives in relation to the particular credit contract or consumer lease in question; and

    (ii) to take reasonable steps to verify the consumer’s financial situation.

    However, the responsible lending assessment itself would continue to focus on the suitability of the particular credit for the consumer, while the distribution obligations would require consideration of whether, at a more general level, the consumer is within the target market for the product (e.g. due to the overall features and costs of the product over its lifetime, and the circumstances of the consumer).

(d) Post sale, lenders would need to review their target market determination for the product where events and circumstances reasonably suggest that the target market determination is no longer appropriate. This might include data on refinances, rates of early payout (to which additional fees may apply), rates of defaults, or requests for hardship applications There are no parallel obligations in the current credit regime.

46 The examples below illustrate the potential benefits of applying design and distribution obligations to credit products.

Example 4: Payday loans

When consumers make a choice to use payday loans they are meeting their short-term needs (for example, accessing $1,000 to pay an electricity bill) at the expense of their longer-term needs (to avoid becoming dependent on an expensive form of finance).

The responsible lending obligations require the lender to only consider the consumer's immediate needs, where the design and distribution obligations propose a more comprehensive analysis of the requirements of the class of consumers that would form the target market for the product. This could result in changes to design, or the clear identification of some classes of consumers who should be offered products on different terms.

Example 5: Home loans

Lenders can offer a range of home loan products with different features and pricing. For example, a lender may offer two similar home loans: one has an offset account that allows the consumer to reduce the amount payable under the home loan by the interest earned on a savings account, and the other does not (but is slightly cheaper).

The responsible lending assessment may identify that both loans are suitable. However, the design and distribution obligation would limit the sale of the home loan with the offset account to identified classes of consumers likely to benefit from it. For example, it may exclude sales of the home loan with the offset account to young consumers on modest incomes, with no capacity to generate savings, or redesigning the product so the offset feature is not priced separately.

47 Additionally, not all credit products are covered by responsible lending requirements, although they are regulated under the ASIC Act: see paragraphs 48–54. This includes lending to small business consumers, certain credit contracts for investment purposes, and other credit products sold to consumers. As discussed below, extending the design and distribution obligations to these credit products would encourage industry to improve consumer outcomes in these markets.

ASIC Act products

48 We believe the design and distribution obligations should cover certain residual financial and credit products that are not regulated by either the Corporations Act or the National Credit Act, but are regulated under Div 2 of Pt 2 of the of the ASIC Act.

49 These products are functionally similar to products regulated under the Corporations Act or National Credit Act, and include certain funeral insurance products, and certain extended warranties (which may be equivalent to insurance products regulated under the Corporations Act). There are also ‘credit facilities’ that are ASIC Act products but are not regulated by the National Credit Act. This includes some short-term credit products that are outside the National Credit Act as they fall within the exemption for short-term credit in s6 of the National Credit Code, and other credit products that are otherwise not regulated by the National Credit Act.

> Note: Section 6 of the National Credit Code outlines types of credit to which the Code does not apply. This includes short-term credit that satisfies certain requirements as to the maximum period of the loan and the maximum amount of credit fees and interest charges that may be imposed.

50 While these products are subject to consumer protection provisions set out in the ASIC Act, this does not provide an equivalent framework to the design and distribution obligations. In fact, such residual products regulated under the ASIC Act but not the Corporations Act or National Credit Act are currently subject to the least regulation (for example, because persons dealing in such products are not required to be licensed and comply with the positive conduct obligations attaching to licensees), resulting in a lower level of protection for consumers accessing these products, and creating incentives for regulatory arbitrage.

51 In the course of our regulatory work, we have identified significant consumer detriment in relation to these products and sought to address the problems, albeit with our existing limited toolkit. This has included products that are poorly designed, and that may provide limited utility to many of the consumers to whom they are regularly sold. We have also seen some businesses deliberately structuring their products to avoid the credit and financial services regulatory regimes, often to the detriment of consumers—such products would also not be subject to the design and distribution obligations (although regulated under the ASIC Act).

52 In view of this, we think applying design and distribution obligations to the full range of financial services and credit products regulated by ASIC would help address some of these instances of consumer detriment, in requiring product providers and distributors to have more robust controls and processes in place.

53 Indeed, while drafted on the basis that they will form part of the Corporations Act disclosure regimes for financial products, the design and distribution obligations are in many ways similar to the consumer protection standards set out in the ASIC Act, in that they provide a foundational framework that sets some universal standards against which more specific regulation is overlain through the financial services regime in the Corporations Act.

54 We acknowledge that including ASIC Act products would require a modified drafting approach, given these products are not subject to a disclosure requirement (where not otherwise regulated under the Corporations Act); however, we think that the design and distribution obligations have the potential to address some of the problems we have seen in this area.

Example 6: Warranties sold with motor vehicles

ASIC has undertaken a broad range of work with insurers to improve consumer outcomes from the sale of their add-on products with cars.

These outcomes include:

- significant refunds totalling over $122 million in recognition of past unfair sales: see Media Release (18-008MR) *Allianz refunds $45.6 million in add-on insurance premiums,* (17 January 2018);
- some insurers voluntarily lowering commissions (from as high as 79% of the premium to around 20% of the premium), and therefore improving the value to consumers, both through lower premiums and in the amount paid back in claims relative to the premium: see Consultation Paper 294 *The sale of add-on insurance and warranties through caryard intermediaries* (CP 294); and
- insurers improving the design of their products, so that they better meet the need of consumers.

However, these changes are not entirely systemic given they have been achieved in some cases through cooperation. Having design and distribution obligations in place would encourage positive change to practices on a more comprehensive basis.

Nevertheless, we are concerned that, if design and distribution obligations are not extended to ASIC Act products, having the obligations in place could encourage regulatory arbitrage.

For example, some car dealers currently sell warranties that are functionally similar to mechanical breakdown insurance (MBI) products, as they cover the cost of repairs to the consumer's car. The providers rely on the exemption in s763E of the Corporations Act for products that are an incidental component to another non-financial product (although they would fall within the extended definition of 'financial product' in the ASIC Act).

ASIC has identified that these products may include discretionary pricing: that is, there is no fixed price and the car dealer sells the warranty for the price at which they assess the consumer will agree to it. For example, a sophisticated consumer may be sold the warranty for $500, and a financially vulnerable consumer sold it for $3000.

ASIC is concerned that some car dealers may respond to the reductions in commissions that are paid on MBI products by electing increasingly offer warranties that are not regulated under the Corporations Act, and increase the price they charge for these products.

> On the other hand, applying design and distribution obligations to products regulated under the ASIC Act, including warranty products that are technically exempted from the Corporations Act, would require issuers of these products to meet the same obligations as insurers offering similar products, including identifying appropriate target markets and distribution channels for their products, to reduce the risk of products being provided to consumers for whom they are not appropriate.

Additional products to be included by regulation

55 The Exposure Draft Explanatory Memorandum notes that the Government proposes to make regulations that would apply the regime to a number of products that do not presently require disclosure under the relevant sections of the Corporations Act, including products exempt from disclosure under an ASIC legislative instruments such as an interest in an investor directed portfolio service.[4]

56 We support the coverage of the design and distribution obligations being as broad as possible, and will work with the Government and the Treasury in their development of regulations to ensure that any products that are technically exempted because they do not presently require disclosure under the relevant sections of the Corporations Act, including where this results from an exemption under an ASIC legislative instrument.

Enforcement and penalties

57 One of the FSI's recommendations was that penalties for contravening ASIC legislation should be substantially increased.[5] We believe penalties set at an appropriate level are critical and need to be available to give market participants the right incentive to comply with the law. They should aim to deter contraventions and promote greater compliance, resulting in a more resilient financial system.

58 In March 2014, ASIC published Report 387 *Penalties for corporate wrongdoing* (REP 387), which identified areas where the penalties available to ASIC to punish corporate wrongdoing are out of step with those available to other regulators both internationally and domestically.

59 In general, we are very supportive of the fact that the exposure draft legislation includes a range of alternative criminal and civil penalty sanctions for contraventions.

[4] Exposure Draft Explanatory Memorandum, pp. 12–13.
[5] The Australian Government the Treasury, *Financial System Inquiry Final Report* (PDF 4.8 MB), report, 7 December 2014, pp. 251–252.

60 However, it is important that the final enforcement and penalty provisions attaching to the design and distribution obligations be consistent with any changes arising out of the work of the ASIC Enforcement Review Taskforce.

61 The ASIC Enforcement Review Taskforce has considered a range of issues relating to ASIC's enforcement toolkit, including the range and level of penalties and other sanctions within ASIC-administered legislation.[6]

62 The Taskforce's work represents an important and systematic review of ASIC's enforcement toolkit. Changes arising out of the Taskforce's work should ultimately be taken into account in settling the final form of enforcement mechanisms and penalties available in relation to the design and distribution obligations, to ensure consistency across the legislation, and that enforcement mechanisms and penalties are set appropriately to ensure the obligations achieve their aims of improving consumer outcomes.

63 In particular, maximum penalties for breaches of the design and distribution obligations should be consistent with any increases to maximum penalties for comparable misconduct under other provisions of the legislation administered by ASIC, made as a result of the Taskforce's recommendations.

64 We make the following comments in relation to specific obligations in the draft legislation and the proposed penalties for those obligations:

(a) the obligation in proposed s993DG to report a 'significant' dealing outside the target market is comparable to the current obligation in s912D of the Corporations Act to report 'significant' breaches of the Australian financial services (AFS) licensing obligations. This obligation has been an area of focus for the Enforcement Review.[7] The final drafting of s993DG should have regard to any final recommendations of the Taskforce on changes to s912D;

(b) the proposed criminal penalty for a breach of proposed s993DG is only 50 penalty units, likewise for a breach by a regulated person of their corresponding obligation under s993DF(5). ASIC considers that this penalty is too low to act as an adequate deterrent and ensure compliance with this important reporting obligation. In our view, the penalty should be comparable to that which applies to a breach of s912D, again having regard to any relevant recommendations of the Taskforce; and

(c) the proposed criminal penalty for failure to comply with a request by ASIC to provide information under proposed s993DH is only 10 penalty units or imprisonment for 3 months, or both. In our view,

[6] See, e.g. The Australian Government the Treasury, *ASIC Enforcement Review: Positions Paper 7 Strengthening penalties for corporate and financial sector misconduct* (PDF 694KB), positions paper, October 2017.
[7] The Australian Government the Treasury, *ASIC Enforcement Review: Position and consultation paper 1—Self reporting of contraventions by financial services and credit licensees* (PDF 796KB), position and consultation paper, April 2017.

this penalty is too low for prosecution to be an effective enforcement mechanism (particularly as this is not a strict liability offence). ASIC's ability to request information is critical to performance of our role as regulator and the penalty for non-compliance should reflect this.

65 We also support the exposure draft legislation providing for a private right of action for consumers affected by breaches of the design and distribution obligations. However, it would also be beneficial to include a provision similar to s12GNB and 12GNC of the ASIC Act, which allow ASIC to take action in relation to loss or damage suffered by a class of persons who are non-party consumers, and obtain court orders requiring a range of different remedial actions.

Objects clause

66 The exposure draft legislation proposes that the following objects clause be inserted after s760A(a) of the Corporations Act to reflect the introduction of the design and distribution obligations:

> The provision of suitable financial products to consumers of financial products.

67 While we support the insertion of an objects clause, we think it could be amended to better reflect the nature of the design and distribution obligations. The objects clause does not elaborate on the meaning of the word 'suitable', nor is this term used or defined in the proposed Pt 7.A. We are concerned that this term could be interpreted as referring to individual suitability—requiring an individual's circumstances to be considered. This term is used in other contexts, including Ch 7 of the Corporations Act (in relation to which the objects clause will apply), where such an assessment is required.[8]

68 As discussed in paragraph 6, the FSI specifically considered imposing an individual suitability assessment, but did not recommend that approach. Instead these obligations are focussed at a broader level on ensuring that financial products are designed and distributed to meet the likely objectives, financial situations and needs of persons in a target market (being a class of persons).

69 We think it preferable to make an amendment to avoid any confusion in the interpretation of the new obligations. We suggest the following wording to better capture the nature and intent of the new obligations:

[8] See for example responsible lending conduct for margin loan facilities: Subdiv A of Div 4A of Pt 7.8 of the Corporations Act; and the responsible lending obligations under the National Credit Act.

the design and distribution of financial products to meet the financial objectives, circumstances and needs of consumers, by ensuring that financial products:

(i) meet the needs of one or more identifiable target markets;

(ii) are sold to consumers in the target markets by appropriate distribution channels; and

(iii) deliver appropriate consumer outcomes.

B Product intervention power

Key points

ASIC welcomes the introduction of a product intervention power that will better equip us to respond to market problems that are causing or could cause harm to consumers.

There is a need for an ASIC product intervention power that covers products regulated under the ASIC Act as well as the Corporations Act and National Credit Act, being the broadest range of financial products and credit products within ASIC's regulatory responsibility.

It is also important for the product intervention power to be comprehensive and flexible enough for ASIC to tailor interventions to the specific circumstances of different market problems, including in relation to training.

A flexible product intervention power is the most effective means to facilitate changes to address market problems.

70 This section outlines our observations on some of the proposals regarding the product intervention power outlined in the paper.

71 Specifically, it covers:

(a) the scope of products that would be the subject of the power;

(b) the types of interventions ASIC could make using the power; and

(c) enforcement mechanisms.

Scope of the product intervention power: Extending product coverage

72 ASIC has broad responsibility for consumer protection in relation to financial products and credit products. Our experience to date in regulating financial products and credit products has helped inform our views on the proposed scope of the product intervention power.

73 We support the proposed approach in the exposure draft legislation that the product intervention power should be able to be applied in relation to:

(a) financial products made available to retail clients under the Corporations Act; and

(b) credit products regulated under the National Credit Act.

74 However, this would also mean that we would not be able to intervene in relation to certain products that fall within ASIC's regulatory responsibility

under the ASIC Act but are not regulated by either the Corporations Act or the National Credit Act. As discussed in Section A, these include certain funeral insurance products, some credit products (including some short-term and continuing credit products), and certain extended warranties.

75 In the course of our regulatory work, we have identified consumer detriment in relation to these products and sought to address the problems, albeit with our existing limited toolkit.

76 In view of this, there is a need for a comprehensive product intervention power that covers the broadest range of financial products and credit products within ASIC's regulatory responsibility. As discussed in Section A, products regulated under the ASIC Act but not the Corporations Act or National Credit Act are currently subject to the least regulation, resulting in a lower level of protection for consumers accessing these products, and the potential for regulatory arbitrage. A product intervention power would enhance our limited ability to take action in relation to these products to address significant consumer detriment, particularly where consumer protection may already be inadequate.

77 We think coverage of the product intervention power should extend to all ASIC Act products—including residual products such as funeral insurance and credit not regulated by the National Credit Act. This definition would cover a broader range of both:

(a) financial products that are made available to retail clients; and

(b) credit products made available to consumers.

78 The example below shows our work in relation to a product that could fall outside the scope of the product intervention power as proposed in the paper because it is outside of the Corporations Act definition of financial product (due to reg 7.1.07D of the Corporations Regulations 2001 (Corporations Regulations)), although it is regulated under the ASIC Act.

Example 7: Funeral insurance

Funeral insurance is a form of life insurance sold to consumers to cover the cost of funerals. Significant concerns about the design and sale of funeral insurance have been identified in Australia in recent years. Policies that provide only for funeral expenses are regulated under the consumer protection provisions in the ASIC Act, but are not subject to the licensing and conduct regime of the Corporations Act.

In Report 454 *Funeral insurance: A snapshot* (REP 454), released October 2015, we reported on our review of the funeral insurance market in Australia based on data collected in 2013 and 2014. The report includes recommendations for improving features of funeral insurance products to potentially address issues raised in the report and elsewhere.

Our recommendations included recommendations related to product design. We observed that during and since the period of the review, some insurers introduced more flexible and improved features into their funeral insurance products. However, we acknowledged that we did not have a product intervention power and were limited to taking action regarding misleading conduct. We highlighted that we did not have powers to prevent funeral insurance products creating situations where consumers are disadvantaged. This has restricted our ability to prevent unfair outcomes for consumers, including Indigenous consumers in remote and regional Australia.

Unless the product intervention power is extended to cover ASIC Act products, we would not have the ability to address these kind of poor outcomes beyond the continued use of suasion where possible.

Example 8 Unregulated payday loans

The National Credit Act has a large number of product-specific requirements on lenders offering payday loans, to address the specific problems these products can cause.

However, the National Credit Act does not regulate some forms of short-term lending (for historical reasons, as they were unregulated by the former State laws in place prior to ASIC assuming responsibility for regulating credit in 2010). These include a business model in which the lender charges low fees but a related company acts as a finance broker, and charges significant additional amounts, making the credit very high in cost to the consumer.

Because these products are not regulated under the National Credit Act:

- The lender does not need to comply with the responsible lending requirements, that is, the detailed assessment of capacity to repay that applies to lenders regulated under the National Credit Act (increasing the risk of default, either on the loan provided to the consumer or to other loans the consumer has with other lenders).
- The consumer often pays more than would be permitted under the National Credit Act, with the likelihood that significant revenue is earned from default fees (i.e. financial incentives encourage poor lending standards). The total cost can be up to 3.5 times more than a payday lender is permitted to charge under the cost caps in the National Credit Act.

If the product intervention power applied to all forms of credit, including those regulated under the ASIC Act but not under the National Credit Act, this would enable ASIC to act where we had found significant consumer detriment in relation to these products (e.g. because of the way they were structured and priced to vulnerable consumers), by designing interventions to mitigate the detriment.

Scope of the product intervention power: Range of interventions

79 The approach proposed in the exposure draft legislation is that ASIC could generally make interventions relating to specified conduct in relation to a product or class of products. However, ASIC could not require a person satisfy a standard of training, or meet a professional standard, other than a standard prescribed for the person by or under the Corporations Act

80 While we understand the need to clearly define the scope of the product intervention power, we think additional flexibility in relation to training is important to ensure that the power allows us to make appropriate, targeted and proportionate interventions to address the particular market problem we have identified.

81 We understand the Government's concern that the product intervention power not be used to impose significant new training requirements. Nevertheless, we think imposing more constrained and targeted training requirements, where limited to the context of improving distribution practices, could be the most appropriate and proportionate response in some situations.

82 The additional element we think would be useful in the scope of the power would be:

(a) an ability to require that the product may only be distributed by staff who have had specific training in the features, benefits and risks of the product;

(b) where that intervention were made as part of an intervention relating to the distribution of a product.

83 We recognise that, to balance the Government's concerns, the scope of the power might need to explicitly exclude ASIC imposing more general training requirements for an industry sector (e.g. setting broad standards, imposing exams or creating or requiring the creation of an infrastructure for doing those things).

84 In fact, while the exposure draft legislation currently limits ASIC's ability to intervene in relation to training, it is unclear whether ASIC might be nevertheless able to make an intervention that might effectively require an element of training to be satisfied, while leaving it to the affected person to determine exactly how this standard of training should be met (e.g. an intervention requiring only employees with sufficient knowledge about a product to deal with clients, with the affected person to determine precisely how its employees should reach this standard of knowledge). To the extent that an element of training might already form part of a legitimate exercise of the power, it would be preferable for both ASIC and industry for this to be made clearer.

85 More generally, it is important that the product intervention power allows ASIC as much flexibility as possible, with appropriate limitations. Without a flexible power, we may not be able to choose a targeted option and would be in the incongruous position of having to consider a blunt, wide-reaching tool—like an outright ban on the sale of the product—even when a less interventionist approach would be more appropriate.

86 Imposing additional training requirements to address a particular issue we have identified is not a novel approach—in the course of our regulatory work, we sometimes accept enforceable undertakings from licensees that include new or additional training requirements (e.g. a program of additional training for employees). However, this type of result is achieved as a negotiated outcome. Having scope within the product intervention power to impose a targeted training requirement in the context of improving distribution practice may allow us to achieve these kinds of results in a more comprehensive manner.

Enforcement and penalties

87 Generally, we are very supportive of the fact that the exposure draft legislation provides for both civil and criminal sanctions for breaches of a product intervention order.

88 However, as discussed in Section A, we also think any changes arising out of the work of the ASIC Enforcement Taskforce may need to be taken into account in settling the final provisions, to ensure consistency across the legislation, and that enforcement mechanisms and penalties are set appropriately.

89 Additionally, similarly to the design and distribution obligations, we think it would be beneficial to include in the enforcement provisions relating to the product intervention power a provision similar to s12GNB and 12GNC of the ASIC Act. These allow ASIC to take action in relation to loss or damage suffered by a class of persons who are non-party consumers, and obtain court orders requiring a range of different remedial actions.

Key terms

Term	Meaning in this document
ADI	Authorised deposit-taking institution—has the meaning given in s5 of the *Banking Act 1959*
AFS licence	An Australian financial services licence under s913B of the Corporations Act that authorises a person who carries on a financial services business to provide financial services Note: This is a definition contained in s761A.
AFS licensee	A person who holds an AFS licence under s913B of the Corporations Act Note: This is a definition contained in s761A.
APRA	Australian Prudential Regulation Authority
ASIC	Australian Securities and Investments Commission
ASIC Act	*Australian Securities and Investments Commission Act 2001*
Corporations Act	*Corporations Act 2001*, including regulations made for the purposes of that Act
Corporations Regulations	Corporations Regulations 2001
exposure draft legislation	The exposure draft of the Treasury Laws Amendment (Design and Distribution Obligations and Product Intervention Powers) Bill 2018
Exposure Draft Explanatory Memorandum	Explanatory Memorandum accompanying the exposure draft of the Treasury Laws Amendment (Design and Distribution Obligations and Product Intervention Powers) Bill 2018
FSI	Financial System Inquiry (2014)
FOFA	Future of financial advice
MBI	Mechanical breakdown insurance
National Credit Act	*National Consumer Credit Protection Act 2009*
National Credit Code	National Credit Code at Sch 1 to the National Credit Act
PDS	Product Disclosure Statement
Pt 9.4 (for example)	A part of the Corporations Act (in this example numbered 9.4), unless otherwise specified

Term	Meaning in this document
REP 365 (for example)	An ASIC report (in this example numbered 365)
RG 172 (for example)	An ASIC regulatory guide (in this example numbered 172)
s961B (for example)	A section of the Corporations Act (in this example numbered 961B), unless otherwise specified
Taskforce	ASIC Enforcement Review Taskforce, established by the Government in October 2016 to review the adequacy of ASIC's enforcement regime, in order to deter misconduct and foster consumer confidence in the financial system.