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Design and Distribution Obligations and Product Intervention Power
Draft Legislation and Explanatory Memorandum

Thank you for the opportunity to provide comments on *Treasury Laws Amendment (Design and Distribution Obligations and Product Intervention Powers) Bill 2018* (the Bill) and the *Exposure Draft Explanatory Memorandum* (the EM).

1. Scope of financial products covered

As per our previous submissions, AFMA understands the rationale for excluding the types of financial products listed in section 994B(3) from the regime, on the basis that they are relatively simple and/or are already separately and sufficiently regulated.

However, as per our submissions in March 2017 and February 2018 in response to the December 2016 Proposals Paper and the draft legislation respectively, we remain of the view that the scope of the regime is unnecessarily broad, and additional categories of products should be excluded from the regime for the same reasons as the products listed in section 994B(3).

We are concerned about the overall increased costs to the financial system that may result if the regime is implemented as currently proposed, particularly in relation to basic banking products. If there are particular basic banking products that are of concern then this should be addressed directly rather than through a blanket application of the law. Alternatively, we re-iterate that consideration should be given to addressing these products through the implementation of the FSI recommendation that simple low risk products such as basic banking products would not require extensive consideration and may be treated as a class, with a standard approach to their design and distribution. Ideally this should be addressed in the legislation, but could also be dealt with by way of ASIC guidance.

We also re-iterate the comments in our previous submission that a key focus of global regulators is the mis-selling of complex products, on the basis that the risk of mis-selling increases in line with the complexity of the financial product. To effectively manage compliance cost and regulatory burden, a risk-based approach proportionate to the risks of detriment to retail clients would create a better balance between the ability of issuers to continue to issue well-understood products in compliance with existing disclosure and other regulatory requirements, and the need to provide greater protections to investors in relation to more complex products.

This approach is in line with the AFMA Guidelines for product approval of retail structured financial products, the IOSCO Principles for regulation of retail structured products and ASIC Report 384 on regulation of complex products.

2. Capital raising

This section comments on capital raising as the product scope is so broad as to have a potentially significant risk of unintended and unanticipated adverse impact on the capacity of Australian entities to raise capital.

It is appropriate that the regime recognises the essential role and importance of capital raising in the growth and development of Australian entities and the economy. Indeed, paragraph 1.27 in the EM says that fully paid ordinary shares are excluded as they are "fundamental to corporate fundraising". Footnote 16 says that the use of the term 'ordinary share' is intended to distinguish such shares from other types of shares, particularly preference shares.

Section 994B(3)(d) of the Bill says that the requirement to make a target market determination (TMD) does not apply to a fully paid ordinary share in a company or a foreign company. However, this wording will not be sufficient to exclude CHESS Depository Interests (CDIs) that are issued in relation to foreign securities, for example, from the requirement to make a TMD.[1]

A CDI is a financial product that is a unit of beneficial ownership in an underlying financial product which is quoted on the ASX market. A CDI confers a beneficial interest in the underlying financial product to which it relates.

CDIs can be settled electronically through CHESS and are used when the underlying financial products are not able to be settled through CHESS. For example, if a foreign company issues CDIs in respect of its shares (financial products), the holders of the CDIs obtain "beneficial ownership" of those foreign financial products. The main difference between holding CDIs and holding foreign financial products directly is that the holder has beneficial ownership in the foreign financial products instead of legal title. Legal title to the foreign financial products is held by a nominee company on behalf of CDI holders. [2]

[1] This does not include secondary trading on the ASX of CDIs over interests in a fund where only brokers or 'Authorised Participants' acting as principal can apply for the issue or redemption of CDIs. Secondary trading of CDIs is excluded from the regime.

[2] https://www.asx.com.au/documents/settlement/CHESS_Depositary_Interests.pdf

It remains unclear why the regime discriminates between ordinary shares and other ordinary securities (such as interests in listed and quoted unit trusts) as these products are used predominantly to provide a basic economic interest in an operating business. Other products that are widely understood by consumers and are often used in fundraising activities should also be excluded. The existing licensing, registration, disclosure and listing obligations already contain strong retail investor protections in the context of advice and distribution of these financial products. This would be more consistent with the recommendation of the Financial System Inquiry and seems to be more in line with the apparent intention of the proposal as put forward by the inquiry.

In circumstances where different kinds of financial products can be issued for fundraising purposes, the application of the design and distribution obligations to those products will be another factor that contributes to the continuing strong bias towards issuing equities in the Australian market, and a continuing lack of portfolio diversification. This is not consistent with the Government's policy objectives.

In certain sectors, it can be a common practice to issue ordinary shares with free attaching options for example. Under revised section 994B(3)(d), the requirement to make a TMD does not apply to the issue of the ordinary shares, but the issue of the options may be captured. It is not clear whether this would then mean the whole issue is captured. Given that the option is an exercisable right over the underlying share, it is not a sensible outcome that the shares are excluded but the options are not. If this is the outcome, it is likely to distort or undermine the capacity of entities to raise equity capital in this way in the future.

A similar issue arises in relation to instalment receipts. As far as we are aware instalment receipts have been a significant part of some major corporate fundraisings in the past, and one commonly used by Government in making asset sales. Given the stated desire in the EM to exclude ordinary shares because they are fundamental to corporate fundraising, we note that instalment receipts have had a similar role in fundraising – for example in various CBA and TLS offers.

While we understand hybrids are within the scope of the obligations, industry would appreciate clear guidance from ASIC dealing specifically with hybrid offers and distribution. It appears that capital raisings by any stapled security structure will be caught. Infrastructures funds (many of which may have stapled structures) will also be caught as they involve managed investment scheme structures; however, they are critical vehicles for fundraising for infrastructure projects.

It is unclear whether the following are also caught by the regime:

(a) Renounceable rights (including those not listed for secondary trading) - this uncertainty may be less relevant to traditional rights issues (ie. that fit within the s9 definition), which are exempt from the disclosure requirements under the Corporations Act and which would not therefore appear to be caught by the new regime. However, this is less clear in relation to non-traditional rights issues (eg. accelerated rights issues), which we understand are generally subject to ASIC relief, rather than an exemption under the Corporations Act.

(b) Rights issues by a listed managed investment scheme - traditional rights issues are generally subject to the disclosure exemption in section 1012DAA and are therefore not expected to be caught by the new regime. However, there is uncertainty in relation to non-traditional rights issues (eg. accelerated rights issues), which we understand are generally subject to ASIC relief rather than an exemption under the Corporations Act, as well as on-sale situations that rely on relief rather than an exemption under the Corporations Act. Practically it would be an irregular outcome to offer a conditional entitlement that parties can purchase on-market, but their ability to take up the entitlement/rights by subscribing for units in the MIS off-market would be subject to a TMD assessment.

3. Personal advice

Clarity is needed as to whether distribution by personal advice is carved out of the design and distribution obligations framework (for both issuers and distributors), or whether it practically means a TMD still has to be produced but can be limited to a statement that distribution to retail investors is via personal advice only.

It appears that the latter is probably the correct interpretation; however clarification is needed to resolve the following uncertainties:

(a) Record keeping and reporting obligations - distributors have to keep records in relation to personal advice clients and make them available to issuers, who are required to review this information and any complaints to determine if the TMD is still effective. Some practical issues arise in making this assessment. For example, in relation to client complaints, it may be difficult to distinguish between a poor performing product or an inappropriate TMD (a design-side issue) or the provision of poor personal advice (a distribution-side issue).

Given these practical difficulties, and the existing regulation of personal advice, it is suggested that where personal advice is given, records should only need to evidence that a client was given personal advice.

(b) Reasonable steps to ensure distribution is consistent with the TMD - it is unclear how an issuer would meet its obligations to take reasonable steps to ensure distribution is consistent with the TMD, when distribution is by personal advice only.

Arguably, distributing the product under a ‘personal advice only’ model would constitute 'reasonable steps', as an advisor would be subject to the existing regulation of personal advice and would have to assess the individual needs of each client.

However, ASIC regulatory guidance would be helpful in indicating, for example, whether a contractual arrangement between the issuer and distributors that requires distribution by personal advice only is adequate, or whether closer monitoring of product distribution by the issuer is required.

Related to this point is the application of the definition of "excluded conduct". We understand that the intent of the regime is to carve out certain obligations from applying to regulated persons (including the maker of the TMD) where personal advice is provided to retail clients. However, the current drafting (for example, of sections 994C(3) – (7), 994D(d), 994E(1) and 994E(3)) operates to carve out the obligations only of the person who is providing the distribution conduct that is "excluded conduct" ie. only the provider of the personal advice is carved out.

This creates an anomaly in that while the provider of personal advice can rely on the exception, the person who makes the TMD (and other regulated persons) who are issuing or also distributing the product are not able to rely on the fact that the personal advice has been provided. This anomaly can be corrected by amending the definition of *excluded dealing* so that it extends to all dealings undertaken for the purpose of implementing personal advice that a regulated person has provided to the retail client, including distribution by accessing a product via an IDPS or super wrap platform.

4. Disclosure of a TMD

In our previous submission we noted that the Bill and the EM were both silent as to whether a TMD needs to be included in a disclosure document given to a retail investor. We had understood from discussions that took place during the earlier consultation sessions hosted by Treasury that the intended purpose of a TMD is for an issuer to communicate to a distributor how the product should be sold, and that the TMD is not directed to consumers. Treasury also indicated at the time that there is no obligation to include the TMD in a disclosure document. AFMA supported this flexible approach to disclosure of a TMD, as there may be circumstances where a TMD or the essential elements of a TMD should be included in a disclosure document but this is appropriately a matter for an issuer to determine in each case.

The Bill has now been amended at section 994B(9) to say that a person who makes a TMD must ensure that the determination is available to the public free of charge.

Despite the comments in the earlier round of consultation about the intended purpose of a TMD and that it was not directed to consumers, we appreciate that there may be reasons why a consumer needs to be able to access the TMD – for example, to assist in determining whether they have been mis-sold a product.

However, as a result of this amendment, the status of a TMD in the context of the disclosure requirements under the law is now even more uncertain.

The Corporations Act and Corporations Regulations prescribe content requirements for disclosure documents, including the requirement under section 1013E that a product disclosure statement includes all the material that might reasonably be expected to have a material influence on the decision of a reasonable person, as a retail client, whether to acquire the product. It would be helpful if a Regulation (or failing that, ASIC regulatory guidance) could clarify that a TMD is not information that is required to be included in a disclosure document under this test.

As we have previously noted, if neither the Regulations nor ASIC regulatory guidance address this matter, it is possible that a due diligence practice of including a TMD in a disclosure document will

emerge regardless. There is also now a concern that consumers will mistake a TMD as disclosure that is provided to them for them for the purposes of making a decision whether to acquire the product. In others words, the consumer may consider that the TMD is an implied recommendation that the product is suitable for them.

To the extent that there are concerns about how the disclosure regime currently operates in practice and consumers' understanding of product disclosure, the design and distribution obligations should assist to ensure that consumers acquire products that are right for them, and not add layers of information that might be construed as disclosure or even advice, but in fact are neither of those things.

It is highly desirable for product issuers, distributors and consumers that this matter is put beyond doubt.

More generally, it is noted that a TMD (except for those that relate to simple, widely understood products) may be a complex technical analysis that will not be easily understood by the average consumer. The disclosure document in relation to the issue of the financial product is the information that is designed for this purpose.

5. Form and content of a TMD

While it is understood that the legislation will not mandate the form and content of a TMD, ASIC regulatory guidance will play an essential role in this space to help ensure that industry broadly adapts to the new regime as quickly as possible and that the regime achieves its intended outcomes. Ideally, the potential for mis-selling of products, and disputes between issuers and distributors about the content of a TMD will be minimised where there are widely understood and accepted practices in relation to the form and content of a TMD. Guidance will also assist in keeping the compliance costs associated with preparation and maintenance of TMDs to a reasonable level.

Guidance will need to be provided on a wide range of practical considerations related to the form and content of a TMD, including:

(a) To what extent are issuers required to go in defining the TMD? There are many operational and administrative (eg. reporting and record keeping) factors that an issuer will need to consider in producing the TMD. These factors may cause one issuer to define the TMD one way (eg. only capturing 50% of the potentially suitable retail client base), and another issuer of a near identical product to define the TMD in much more granular detail (eg. capturing 95% of the potentially suitable retail client base). Both TMDs could be considered reasonable, so long as the respective TMD did not capture any unsuitable clients, however they will potentially be categorising client types in many different ways.

    This approach to producing a TMD (ie. taking into account related operational and administrative burden and cost) is potentially in conflict with normal issuer disclosure practices, such as PDS disclosure, and considerable caution will be needed in providing TMDs to end clients. A TMD is likely to be a complex technical analysis and there is concern about

the capacity of investors to understand reasons for the variation in TMDs between issuers with comparable products. The form and content of a TMD is more likely to be appropriate for a sophisticated audience.

There may be scope for ASIC to provide further guidance on how it expects issuers to make the TMD available to the public (ie. only upon request from a retail client, or must it be published online?) so that issuers can appropriately balance the need for transparency with the need to ensure that any information given to a retail client is not inadvertently confusing.

(b) It is conceivable that there would be TMDs that have a multiple tests for determining if a client is within a TMD – so for example Test 1: Client is provided Personal Advice, or Test 2: Client satisfies a number of other separate categorisation attributes. Obviously having two separate criteria within one TMD adds to operational and administrative processes and costs, however it should be up to the issuer to determine if they are prepared to take that administrative burden on themselves and in doing so impose that complexity upon retail distributors of that product. As noted in point (a) above, a competitor issuer should equally be free to adopt the simpler TMD (ie. including only "Test 1")).

It is highly desirable to avoid, as far as possible, the complexity and costs that are reportedly arising in some cases to comply with the suitability and appropriateness requirements under MiFID II. While our members do not envisage having processes in place where algorithms recalibrate the target market daily or even intra-day for a financial product for example, it is important that policy makers and ASIC take a sensible approach to the requirements that enables a consistent methodology to be applied among product classes. That is not to say that a consistent methodology should produce the same outcome across the product class, or that issuers should not perform a careful assessment in relation to each product.

6. Reasonable steps to ensure consistency with TMD

As highlighted in our previous submission, the application of the obligations in section 994E to listed and exchange traded products will be problematic for both the issuer and the distributor.

Section 994E has been amended to clarify that a person is not taken to have failed to take reasonable steps merely because the 'retail product distribution conduct' of a regulated person in relation to the product is inconsistent with the TMD, or because a retail client who is not in the TMD acquires the product. However, there is still an inherent assumption in section 994E(5) that there is a relationship between the person who makes the TMD and the distributor. Although an issuer of an exchange traded product can make and publicise a TMD, an issuer will often have no contractual relationship with the distributor of the products and may not know who the distributors are (as one of the key functions of financial markets is anonymity). It is therefore remains unclear what if any 'reasonable steps' are required to be taken under section 994E(1) by the issuer.

If it is the case that the requirements under section 994E are intended to be scalable, it might be that minimal action is required by an issuer in relation to the distribution of exchange traded

products in order to satisfy the reasonable steps test. In previous discussions with Treasury, it was indicated to us that if it is not reasonable for the person who makes a TMD to have a relationship with the distributor, then 'reasonable steps' will not require such a relationship to exist, and that this would be clarified either in the Bill or the EM. It is not clear that section 994E has achieved this.

Another concern related to this point is that the broad operation of this regime may unintentionally disadvantage retail consumers by reducing the range of investments available to them. For example, a "significant dealing" under section 994G may not indicate a new circumstance or trigger event under section 993D and may actually be the result of an inappropriate distribution by a regulated person (distributor). However, as currently drafted, sections 994D3(3), (4) and (5) would operate to require the maker of the TMD to take steps to prevent the issue and distribution under the TMD of the product at all, as soon as reasonably practicable and within 10 business days. This would seem to be an unfair result for the retail consumers who would otherwise fall within the TMD and creates additional complexities where the product is distributed via a platform.

7. Record keeping and notification obligations

AFMA members support the purpose and objectives of the record keeping and notification obligations. However, we do not support the provisions in their current form that allow for widely varying and divergent information requirements right down to a single product level. This will be complex and costly – from an issuer's perspective there is a concern that distributors will not be willing to accommodate issuer-specific information requests, and from a distributor's perspective there is a concern about issuers requesting varying levels and types of information.

We understand that the provisions were amended to accommodate concerns about the need to collect and notify information about a very large volume of customers for some financial products. A more pragmatic approach might be to simplify the kind of distribution information that is required to be kept, or to only require a record to be created when there is a material change – for example, if and when the distributor changes its reasonable steps to ensure consistency with the TMD.

Another suggestion is that instead of issuers needing to verify all records, the recording of information and reporting information to issuers could be split into two components:

(a) distributors must retain records demonstrating that clients were assessed with respect to the applicable TMD at the time of transaction; and
(b) distributors must report periodically to the applicable issuer if they have experienced any complaints or operational/administrative failures in relation to a product offered by that issuer.

Reporting requirements could also be adjusted so that:

- records are not required to be maintained, or provided to issuers, where it is determined that client is outside of a TMD (and does not acquire the product);
- records do not need to be made available to the issuer if the product is not acquired;
- records do not need to be made available to the issuer if personal advice is provided - however details of any complaints should still be provided to the issuer;

- reports of information by distributors to issuers should be aggregated and presented as information in relation to a client class – that is, reporting should not be required at the individual client level. This is in line with the regulatory approach taken by ESMA in their regulatory guidance; and
- reports of complaints provided by distributors should not be required to include specific client details but should only be required to provide an overview of the nature of any complaints received. This is in line with the regulatory approach taken by ESMA in their regulatory guidance.

8. Transition period

Given the scale of these reforms, including the application of the design and distribution obligations a large number of the financial products that are available to retail customers, the significant process re-engineering that will be required for both issuers and distributors, and the lack of ASIC regulatory guidance until after the legislation is finalised, a transition period of 2 years will be too short.

We suggest a transition period of 3 years, which will allow for up a year to settle the ASIC policy, followed by 2 years of build and implementation by industry. We are mindful of other significant changes already underway or being considered in the financial services sector, including the implementation of the FASEA regime for financial advisers, the implementation of the BEAR regime for ADIs, ASIC's proposal to introduce a new licensing regime for foreign financial service providers, and the outcomes of the Royal Commission which is likely to produce further recommendations for reform.

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Please contact me on [redacted] or [redacted] if you have any queries about this submission.

Yours sincerely

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