Law Council
OF AUSTRALIA

Business Law Section

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Ms O'Rourke
The Manager
Consumer and Corporations Policy Division
The Treasury
Langton Crescent
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By email: ProductRegulation@treasury.gov.au

Dear Ms O'Rourke

Submission on Treasury Laws Amendment (Design and Distribution Obligations and Product Intervention Power) Bill 2018

The Corporations Committee of the Business Law Section of the Law Council of Australia (**Committee**) welcomes the opportunity to comment on the second Exposure Draft Treasury Laws Amendment (Design and Distribution Obligations and Product Intervention Power) Bill 2018 **(Exposure Draft)** and the accompanying Explanatory Materials (**Draft EM**), which were released for comment on 20 July 2018.

Preliminary comments – significant improvements in the Exposure Draft

The Committee acknowledges that it is clear from the Exposure Draft that submissions from the initial consultation process were given serious consideration, and the draft reflects many significant improvements. This is an important acknowledgement, as the changes made have addressed some of the key concerns regarding the earlier draft, and we consider that they will improve the clarity of the legislation and go some way to improving the practicality of the new regime.

In particular, the:

- improved clarity regarding the exclusion of secondary trading on securities exchanges;
- acknowledgement that ordinary shares of both Australian and foreign-registered entities should be excluded (although there are some practical anomalies regarding depositary interests necessary to trade foreign shares);
- attempt to allow issuers and distributors a degree of flexibility in determining the appropriate way to respond to the regime, for different types of products and in different contexts;
- clarification that question to determine target market eligibility do not constitute personal advice;

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- clarification as to whether a target market determination should be made available as part of a disclosure document;
- move from a concept of a product *meeting* client objectives to being *consistent with* those objectives;
- acknowledgement that issuance outside a target market determination will not necessarily suggest a breach of the obligations on issuers and distributor;
- concept of retail product distribution conduct being narrower than "dealing"; and
- extension of time for implementation for new products (although we note that there may need to be some flexibility preserved to extend this period if necessary),

are important and welcome improvements.

The regime has also sought to strike a more practical balance than its European equivalent (in the Markets in Financial Instruments Regime (**MIFID II regime**)), and this is also an important positive feature of the proposed legislation that deserves recognition.

Continuing concerns regarding the regulatory framework

It is important to continue to emphasise that – if passed – this legislation will represent a fundamental change in the philosophy underpinning Australian securities law regulation. That philosophy will move from traditional disclosure regulation (with "sunlight" relied upon to create a deterrence effect, an informative effect and an enforcement effect) towards a form of merit regulation, including a new approach of placing responsibility on issuers and distributors of financial products to restrict (and accordingly, to some extent determine) the choices of products available to retail clients.

Inherent in this change is the risk that investor outcomes will not improve, because it creates a moral hazard – that investors will feel entitled to ignore balanced and fulsome disclosure. As with historical examples of merit regulation, there is also a significant risk that the new regime will prove to be impracticable to implement and administer, and that the costs to business will far outweigh any benefit to consumers.

Practicalities of implementation

The new regime will involve industry participants undertaking novel tasks of categorising products and investors and implementing systems and processes which do not currently exist.

There will be countless practical issues that emerge as regular product issuers and distributors seek to build systems to respond to the new regime, and as occasional product issuers seek out service providers (who may or may not currently exist) to support their new compliance needs.

For the regime to achieve its policy goals without undue impact on the viability of providers and the price of services for consumers:

- the regime must be flexible in its application, given that industry submissions seeking to exclude certain product types were not heeded;

- the practicalities of implementation must be supported by early guidance in the Explanatory Memorandum (to clearly indicate the intent of the regime, and to assist a pragmatic interpretation of the legislation), from Australian Securities and Investment Commission (**ASIC**) and through industry bodies;

- ASIC must be encouraged in the Explanatory Memorandum to be swift to grant relief where it appears that the legislation has consequences beyond the original intent of the legislation, and to support a pragmatic approach to implementation (including where the costs of compliance render products that are regarded as beneficial for retail markets, unaffordable);

- ASIC should be encouraged to make use of its broad modification power to assist segments of the market to have certainty as to what represents "sufficient" compliance in particular contexts; and

- it is important that the regime should not impose unnecessary legal or regulatory risk, which could incentivise exploitation of the regime, lead to a dysfunctional approach to compliance or trigger a significant withdrawal of beneficial products from the retail market.

Key remaining drafting concerns

There are three significant remaining concerns that could be addressed without undermining the policy intent of the regime:

1. **Certainty.** Issuers and distributors will need certainty as to what documentation and conduct will be sufficient to comply. As well as any Regulations and ASIC Regulatory Guides being released around the same time as passage of the legislation, which we understand is intended, the legislation should include comfort that industry consensus views on implementation will not offend competition laws.

2. **Remedies.** Investor remedies for breach of the regime should be through regulatory action and compensation orders, not direct securityholder rights of action. A requirement to consider the appropriate target for distribution of a product should not be distorted (and potentially exploited) through the class action mechanism into an effective guarantee of capital and returns.

3. **Intervention orders.** ASIC should be required to allow issuers an effective window to address issues with a product before a product intervention order is published. This is especially important given that this regulatory tool can be used without actual or suspected breach of any law.

Monitoring the new regime

Given the significance of the impact of this regime (both the design and distribution obligations, and the product intervention powers) upon broader securities laws, and the policy that underpins them, we recommend that the regime be monitored closely for several years after its commencement, and that industry consultation should be held at intervals during the preparation period and following commencement.

Finally, we continue to recommend that consideration be given to a commercial panel to which concerns regarding the use of regulatory powers in relation to these new regimes can be escalated, at least in respect of their proportionality and commercial reasonableness – rather than requiring a tribunal application within limited parameters.

Further details

Further detail in relation to certain of these submissions, and some technical changes to the legislation that are warranted, are set out in the Schedule below.

If you have any questions or comments on this submission, please do not hesitate to contact Shannon Finch ([redacted] or [redacted]) or Glenda Hanson ([redacted] or [redacted]).

Yours sincerely

Rebecca Maslen-Stannage
Chair, Business Law Section

Schedule – submissions

1. Certainty in implementation

1.1 Explanatory Memorandum and ASIC guidance

In deciding whether guidance on interpretation and implementation of the regime should be given in the Explanatory Memorandum that accompanies the Bill, or left to be addressed in ASIC Regulatory Guides, we ask that Treasury take into consideration the legal principle that a court may take statements in an Explanatory Memorandum into account in interpreting legislation.

On significant issues, such as what is required to prepare a valid target market determination (**TMD**), guidance in the Explanatory Memorandum will support the ability to give clear legal advice to issuers and distributors in the unchartered waters of this new paternalistic style of legislation.

In addition – if the legislation is intended to be interpreted, applied and administered in a pragmatic way, then this should be clearly expressed in the Explanatory Memorandum.

Lack of clarity in the law can result in costs and delays, and damage business confidence

1.2 Effective implementation without offending competition laws

A specific legislative provision is needed to ensure that cooperation in developing industry-wide compliance practices, such as agreeing consistent terminology, and developing templates for target market determinations and protocols for information flow between issuers and developers, is taken not to amount to collusion to control access to markets under competition laws. Also, it would be in the interests of comparability of products for investors if issuers were able to have open conversations to reach consensus on categorisation of product types.

2. Civil liability

2.1 Complying with the regime should not be high risk

In the past, attempts by Government to encourage brief and genuinely accessible financial product disclosure have failed, largely because issuers have feared that omitting material or not conducting a fulsome due diligence process will be a basis for liability.

This regime is at risk of creating further, expensive, “over-compliance”. In the age of class actions, providing investors with a direct right of action creates the moral hazard that they may take no personal ownership of their investment decisions, and effectively seek a guarantee of investment returns through the class action mechanism (with its corresponding tendency to drive settlements of claims without testing the claim, in light of the expense involved).

It is not consistent with the policy of this legislation to have issuers underwrite market risk[1] .

2.2 Recommended approach

The minimum change is to modify section 994M(1)(b) should be modified by replacing "whether or not" with "if", so that ASIC and the courts can act as a filter as to whether an action for compensation is appropriate (although by itself this will not prevent misuse of class action procedures).

Ideally, the provision would be deleted entirely, and remedies available in connection with civil penalty provisions in the usual manner under part 9.4B (Civil consequences of contravening civil penalty provisions). Regulatory action, rather than a direct right of investor action, is more than sufficient to safeguard investor interests given the breadth of the sanctions available under Part 9.4B. It would then be more likely to be implemented and enforced in a manner consistent with ASIC policy.

In particular, we note that one basis for liability under the draft section 994M is failure to review a target market determination during the review period. As this period is set by issuers in the TMD and is not fixed, it is not an appropriate basis for civil liability for loss.

The case for deleting section1023Q is even stronger, because a product intervention order is not required to be based on an actual or suspected breach of the law. A discretionary intervention by ASIC may with the benefit of hindsight turn out not to have been warranted, but the civil right of action would be enlivened and could not then be extinguished.

3. The product intervention power and consultation

3.1 Timing of product intervention

Although section 1023F(1) requires ASIC to consult persons who are reasonably likely to be affected before making a product intervention order (**PIO**):

- ASIC can effect the consultation by publication on its website (section 1023F(2)); and
- under section 1023L, it is mandatory for ASIC to publish the PIO on its website when it is made.

In this context, where no basis in actual or suspected breach of law is required, and publication of an intended or actual PIO could ruin an issuer's reputation and irreparably damage the value of their business, a protection from the potential for hasty or ill-considered regulatory action must be enshrined in the legislation.

[1] As the Companies and Securities Advisory Committee observed in the 1993 report Collective Investments: Other People's Money, "It is not practicable or economically efficient for laws and regulations to try to protect individual investors from a fall in overall market values or a decline in value of a particular investments. The law governing collective investment schemes cannot – and should not – eliminate investment risk. The cost of doing so would be too great, and fund managers would be discouraged from devising innovative financial products." This remains true today.

4. Technical issues

4.1 Foreign Shares

We welcome the amendment of the draft section 994B(3)(d) to extend the exclusion for ordinary shares, to ordinary shares in a foreign company. However, foreign shares are only able to be traded on market through the mechanism of a depositary interest (e.g. a CHESS Depositary Interest or **CDI**), which is a separate financial product. Depositary interests over foreign shares should be stated in the section to be expressly excluded, so that the provision can have the intended effect.

4.2 Products which offer rights over other securities

Some financial products offer a right to acquire another underlying product or offer some kind of indirect interest in an underlying product.

It should be clear that, where an underlying product is itself exempt (eg ordinary share or foreign shares), the TMD requirement should relate to the product which offers the right in the underlying product – rather than creating a TMD obligation in relation to the underlying product.

For instance – for a hybrid security that includes a notional conversion right into ordinary shares, it should be clear that the TMD should focus on the market that is able to understand and accommodate the complexity and risks of the hybrid security itself, rather than the ordinary shares that it might convert into.

In some cases, the issuer of the "primary" instrument will not be the issuer of the underlying exempt product, for example, warrants or unsponsored depositary receipts over ordinary shares or foreign shares. Similarly, in these cases, we submit that (at least where the underlying security is exempt) it will not be appropriate for the TMD requirement to apply at two levels to what is effectively one product offering, and the issuer of the warrant or depositary receipt should only have to focus on the "primary" instrument.

Where the underlying product is not exempt or is restricted to wholesale investors (for example, units or other pass through interests in third party wholesale bonds), then the issuer of the primary product should be able to rely on publicly available information regarding the product from the issuer of the underlying product, to meet its TMD obligations – and should not be required to look beyond that information.

In addition, where these sort of products are not considered fundamentally unsuitable for retail investors, then the regime should not be applied in a way that creates a cost structure that renders them non-viable for retail markets. The regulatory supervision of this regime should be required to have some regard to the proportionality and cost of the compliance measures in the relevant context.

4.3 Wording of personal advice exclusion

Although we are supportive of the changes that excluded the actions required to comply with the design and distribution requirements from the definition of personal advice in section 766B, we are concerned at the use of the word "solely". When an issuer obtains personal information from a prospective investor, it may be for this purpose but also for completion of an application form or to satisfy anti-money laundering (**AML**) requirements. The exclusion could be crafted so that it is stated to apply:

- to the extent the steps are taken for the purpose of determining or reviewing a TMD; or
- where the issuer has considered the information in seeking to comply with its obligations under Division 2 of Part 7.8A.

4.4 Advised channels

We are supportive of the changes that permit advised channels to distribute products outside the parameter of an issuer's TMD.

However, where an issuer proposes to distribute solely via advised channels – this does raise the question of whether that issuer should be put to the expense of preparing a TMD at all. It is not clear what purpose the TMD would serve in that situation.

4.5 Support for portals to assist execution-only brokers

Given the regime does not appear to encourage the development of "standard" market classifications or segmentation, it raises a question about the viability of distribution of products on an execution-only basis by brokers. Where issuers of financial products set 'bespoke' criteria in a TMD, brokers may be unwilling to seek out this information without significantly increasing distribution costs, and timing.

We envisage that, as implementation of this regime matures, issuers may use application portals (including via third party service providers) to gather this information, rather than relying solely on distributors. In our view, this does not compromise the intent of the legislation, and it should be accommodated.

4.6 Investor representations and warranties

In informal commentary, we understand that there is some reluctance to permit issuers and distributors to rely on representations and warranties from investors. This would be impracticable and unreasonable. If an investor makes a deliberate misrepresentation to obtain access to a financial product, they should not be entitled to the protection of the regime and issuers and distributor who have acted honestly should not have any exposure in that situation.