



# Treasury Amendment Laws – Design and Distribution Obligations and Product Intervention Power

18 October 2018

## Introductory Comments

1. While ISA is broadly supportive of the Design and Distribution Obligations (DDOs) and Product Intervention Powers (PIPs) being redrafted in-line with the original policy intent, we oppose the current drafting.
2. In 2014 the *Financial System Inquiry*<sup>1</sup> acknowledged that the financial services disclosure regime was a flawed means of protecting consumers. The Inquiry therefore recommended that Australian Securities and Investments Commission (ASIC) be granted DDOs and a PIP. ASIC's submission to the FSI laid out the case for why this was required<sup>2</sup> - to prevent consumer harm before it happens and to make issuers more responsible for product design and mis-selling.
3. Four years has passed since the FSI made its recommendations and progress to implement them has been slow. Either implementation hasn't been a priority or there has been significant opposition to it from parts of the financial services industry - or both.
4. ISA is aware that the consultation process on the draft legislation has been heavily influenced by arguments made by some in the industry that the regime would be unworkable for product issuers. Given the case studies before the Royal Commission we think the purpose of the DDO and PIPs need to be reconsidered from the perspective of consumer protection rather than product issuers. It appears that vested interests in the financial retail banking, advice, insurance and wealth management sectors have been successful in securing carve-outs from the legislation. The Committee now has an important opportunity to re-consider those carve outs.
5. If the carve-outs proceed it is doubtful the design and distribution obligations will be enforceable in practice.
6. These carve-outs are being proposed at a time when the Banking Royal Commission has recently uncovered a series of horrific case studies of significant harm and detriment to many hundreds of thousands of consumers. They suggest that much of the financial services industry - and Treasury as the key policy regulator - are failing to learn from the lessons of the Royal Commission.
7. If the design and distribution obligations and product intervention power had been implemented earlier and in line with the original policy intent of the *Financial System Inquiry*, then arguably some of this consumer harm could be mitigated and perhaps avoided.

## What was the original policy intent?

8. The design and distribution obligations and product intervention powers were conceived of to address shortcomings in the ability of disclosure to protect consumers. They aim to make product issuers / manufacturers more responsible for the design, marketing and distribution of their products. Currently the Corporations Act passes this responsibility down the food chain to consumers via disclosure (and *caveat emptor*) and onto advisers via personal advice obligations (the best interest duty). The thinking behind shifting responsibility up the food chain has been

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<sup>1</sup> Financial System Inquiry (2014), Final Report, pp 406 to 413.  
[http://fsi.gov.au/files/2014/12/FSI\\_Final\\_Report\\_Consolidated20141210.pdf](http://fsi.gov.au/files/2014/12/FSI_Final_Report_Consolidated20141210.pdf)

<sup>2</sup> Australian Securities and Investments Commission (2014) "Submission to the financial system inquiry" April.  
<https://download.asic.gov.au/media/1311553/ASIC-submission-to-the-Financial-System-Inquiry-4-April-2014-1.pdf>

influenced by the UK Financial Conduct Authority and the product suitability measures in MIFID<sup>3</sup>. Moreover, it is in-keeping with global regulatory practice.

9. To this end, a key original objective of the DDOs is to ensure that product issuers / manufacturers and distributors consider and define their intended target market and how they distribute to consumers in that target market. Originally the first draft of legislation also required them to think about who the product was not suitable or not appropriate for (called the ‘non-target market’). This very important requirement has since disappeared from the drafting now being proposed by Treasury.
10. If ASIC determines the product is not appropriate then the PIP allows them to suspend sale/distribution temporarily until the issues are addressed. We will make some comments on the scalability of the PIP but the majority of this submission will focus on the DDOs.

### **Target markets and non-target markets**

11. The DDOs requires the product issuer/manufacturer and distributor to make a product market determination. They must identify who the product is to be sold to and try to work out if there are cohorts of customers who do not fit this market determination. Customers outside of the target market determination would presumably be remediated and/or have an actionable cause.
12. An earlier draft of the legislation required issuers and distributors to also define a non-target market cohort (who the product is not suitable or appropriate for). Unfortunately, non-target market was then removed from subsequent drafts of the legislation. Treasury have offered very little explanation for this removal. We are left to presume this was done because some industry participants argued that it was too hard to determine who the product was inappropriate for without it becoming personal financial advice.
13. This issue could have been dealt with by clarifying that determination of a non-target market for a class of customers does not constitute personal financial advice.
14. The removal of non-target market requirements raises the prospect of issuers/manufacturers defining target markets as broad as possible to minimise the risk of non-compliance. To quote one industry participant “that means my target market is anyone with a pulse<sup>4</sup>”. Non-target markets are important because they make product issuers responsible for working out who a product shouldn’t be sold to (for example, vulnerable consumers, people whom are likely to be not eligible, or unable to use or claim on the product, or consumers that the product might do harm to).

### **A general point about how DDOs interact with duties and other suitability requirements**

15. In the first exposure draft Treasury took the view that credit products should be exempt because the responsible lending obligations would in effect overlap and provided an existing suitability regime. This unfortunately opened up a line of argument for the wealth management organisations and financial advice groups to argue that the best interest duty provides similar obligations. In the final exposure draft personal financial advice was therefore exempted from the DDOs.

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<sup>3</sup> MIFID and MIFID ii are a range of financial services protections that have been phased in as part of European financial market integration. They include product suitability measures, controls around research, and other investor protection measures.

<sup>4</sup> That statement has particular significance given the deduction of advice fees and insurance premiums from deceased customers.

16. However, it is not clear why the DDOs cannot sit alongside an adviser's obligations to act in clients' best interests. One is in relation to a class of investors, the other is in relation to an individual's personal financial circumstances. The scope is different, and personal advice is a critical distribution channel. Consumers would expect advisers to be subject to the same obligations as the issuer – particularly where the adviser is giving personal advice from within a vertically integrated financial institution.

### **My Super and Choice switching**

17. ISA's interest in the DDOs and PIPs stems from switching and misselling activity in parts of the superannuation industry. While MySuper products are exempted from the DDOs, DDO effectiveness is still important, especially given findings from RiceWarner that most switching leaves consumers' worse off<sup>5</sup>. For example, customers suited to low fee default funds are switched into higher fee Choice products. We had hoped that the suitability obligations in the DDO would apply to Choice products. However, we believe it is possible, and likely, that Choice super funds and investment platforms will adopt a broad definition of target market to encourage members who have joined through the default MySuper process to transition to choice products that could leave them substantially worse off. This is often undertaken through general advice via teller or counter sales, to avoid giving personal advice and so side-step the best interest duty.
18. Nonetheless, MySuper products are quite different from Choice super products. The original exposure draft and subsequent ones exempt MySuper products from the regime. The key reason for this is MySuper is a prescribed product. Its features are specified in legislation and its design is therefore prescribed in law to be a universal default product. ISA sees merit in this given the product features of MySuper can only be changed by legislation and the target market is universal default.

### **Royal Commission Case Studies and the DDOs and PIPs**

19. For illustrative purposes the following table examines the Royal Commission case studies and estimates what impact the various drafts of the DDO and PIPs may or may not have had on the consumer harm taking place. We accept this exercise is slightly speculative, however what it does show is, during the Royal Commission, the DDOs in particular have been watered down to the neglect of consumers.

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<sup>5</sup> From analysis of data between 2013 and 2015, RiceWarner concluded that "the aggregate fee outcomes from switching activity reveals a net increase of \$137 million in fees." RiceWarner, *Member Switching*, September 2017, p. 3.

Case study	Financial service area <sup>6</sup>	Would the first draft of the DDOs legislation aided those effected in the case study?	Would the current draft of the DDOs aided those effected in the case study?	May the PIP have been of some use in helping ASIC engage with the issue?
NAB's 'Introducer' program, in which non-financial experts received commissions for home loan referrals	Consumer lending	No	No	Yes
Aussie Home Loans continuing to collect trailing commissions on \$70m loan book of a terminated broker	Consumer lending	No	No	Yes
Westpac offering over a million customers credit card limit increases, without personal circumstances checks	Consumer lending	No	No	Yes
CBA admitting to conflicts of interest in commission arrangements involving its mortgage brokers at wholly-owned subsidiary Aussie Home Loans	Consumer lending	No	No	Yes
Aussie Home Loans found to have insufficient fraud detection systems, after a broker submitted loan applications based on fake documentation	Consumer lending	No	No	Yes
CBA selling 56,000 customers credit card protection insurance products on which no claim could be made	Consumer lending/insurance	Yes	No (non target market determination dropped)	Yes
ANZ issuing pre-approved overdraft facilities, and continuing to do so after ignoring ASIC's request to remediate negatively affected customers	Consumer lending	No	No	Yes

<sup>6</sup> All consumer lending was exempted from scope of the DDO in the first draft. This is not to say DDO obligations if implemented correctly couldn't address consumer lending issues without clouding the responsible lending obligations.

AMP continuing to charge customers, transferred to a 'buyer of last resort' pool following departure of regular adviser, for financial advice not received	Financial advice	No	No	Yes
AMP charging customers of investment platform for advice, despite them not having opted in to service	Financial advice	Yes	No (personal advice exempted from the DDO)	Yes
CBA engaging in substantial 'fees for no service' activity, resulting in customer refunds totaling at least \$118.5m. Other advice providers also implicated	Financial advice	Yes	No (personal advice exempted from the DDO)	Yes
Several entities, including CBA and NAB, charging advice fees to deceased customers	Financial advice	Yes	No (deceased customers would have been part of the non-target market determination but dropped from the DDO)	Yes
A Westpac customer receiving advice that led to loss of her family's home. The planner received more than \$30,000 in commissions. After two inadequate compensation offers, the Financial Ombudsman Service (FOS) found the advice to be inappropriate	Financial advice	No related to the best interest duty.	No	Yes
Numerous entities devising strategies to maintain post-FOFA grandfathered commission arrangements	Financial advice	Yes (question of whether grandfathered commissions are appropriate for some target markets)	No (non-target market has been dropped from the drafting)	Yes

NAB financial advisers forging initials of customers and falsely witnessing beneficiary nomination forms	Financial advice	No	No	Yes
Dover Financial Advisers hiring a number of advisers it knew had been previously cited for misconduct or were under investigation by former employers at the time. Two were later banned by ASIC	Financial advice	No	No	Yes
A Bank of Queensland branch manager allowing a last-minute change to a customer's loan agreement, which rendered her unable to make payments	Small and medium enterprise (SME) lending	No	No	Yes
CBA unilaterally revaluing a pub owned by a customer and his brother, leading to the customers needing to immediately repay their loan facility. The pub was later sold by the bank for substantially less than the revaluation	SME lending	No	No	Yes
Westpac refusing a customer access to \$100,000 of his own funds, after subsidiary Bank of Melbourne had processed application as a residential, rather than commercial, loan, to help meet bank sales targets	SME lending	No	No	Yes
ANZ placing significant pressure on its small business team to attract new customers, despite associated impact on due diligence. Exemplified by example of a \$220,000 loan being secured with an inadequate business plan; later condemned by the FOS as a loan that should not have been made	SME lending	No	No	Yes

NAB taking proceeds from a customer's property sale to pay the customer's business loan, despite the property not having been secured against the loan in question	SME lending	No	No	Yes
Rural Bank and ANZ among numerous entities falsely witnessing the signing of loan statements	Rural and regional customers	No	No	Yes
A number of banks engaging in devaluation, and coercing the sale of rural properties by customers. Highlighted by ANZ's fast-tracked acquisition of Landmark, which led to 162 farmers losing their land	Rural and regional customers	No	No	Yes
A car dealer targeting members of an Indigenous community known to have received emergency relief payments after Cyclone Yasi with interest rates of 48% on car financing	Rural and regional customers	No	No	Yes
ClearView's sale of accidental death cover, including after they were made aware of ASIC's view that accidental death cover was of limited benefit to consumers.	Insurance	Yes (question of whether the Accidental death cover was appropriate)	No (determination of the non-target market has been withdrawn from this draft)	Yes
Clearview's estimated 300,000 breaches of anti-hawking provisions as a result of their unsolicited direct telephone marketing of life insurance and accidental death cover.	Insurance	Yes (they would be required to determine if telephone sales was the appropriate distribution method)	No (determination of the non-target market has been withdrawn from this draft )	Yes



Freedom’s direct telephone sales of life insurance, including selling funeral, accidental death, and accidental injury insurance to a man with Down syndrome.	Insurance	Yes (they would be required to determine if telephone sales was the appropriate distribution method and non-target market determination )	No (determination of the non-target market has been withdrawn from this draft )	Yes
CommInsure’s use of outdated medical definitions in their life insurance policies that provided trauma cover.	Insurance	Yes (outdated medical definitions would have had to been reconciled with non-target market determination )	No (determination of the non-target market has been withdrawn from this draft )	Yes
TAL’s use of “fishing expeditions” to find unrelated client non-disclosure to avoid paying claims.	Insurance	No	No	Yes
AIA and REST’s requirement that those with group life insurance have a minimum balance in the superannuation account.	Insurance	Yes (relates to target market determination )	Relates to target market determination	Yes
AMP and NM’s conflict of interest regarding their use of related parties (AMP Life) with no tender to provide their group life insurance policies.	Insurance	No	No	Yes
Misleading and deceptive advertising by Allianz for its travel insurance policies, including the absence of disclaimers.	Insurance	No	No	Yes

#### Specific Comments on the Current Exposure Draft

The following is ISA’s most recent comments on the current exposure draft that we provided Treasury as part of the consultation process.

## 1.1 Specific Commentary on Exposure Draft 2018

### 1.2 Issuer Obligations – Making a Target Market Determination

Schedule 1, paragraph 994B(8)(a)

We make no specific comment.

Schedule 1, paragraph 994B(8)(b)

ISA considers this an unnecessary dilution of the obligation.

Regulatory Guidance would be sufficient to address any concerns that the previous provision would not be required to meet ‘all’ of the objectives, financial situation and needs of the target market and issuers.

ISA, consistent with our comments above, also believes the Statement should specify where it is likely to *not* be consistent with the likely objectives, financial situation and needs.

Schedule 1, subsection 994B(9)

ISA supports the addition of the provision requiring issuers to make target market determinations available to the public free of charge. However, we believe these should be publicly available regardless of whether it is requested or not – i.e. in the PDS or on an appropriate disclosures website.

### 1.3 Distributor Obligations – Scope of Regulated Distribution Activity

Schedule 1, subsection 994A(1), definitions of ‘retail product distribution conduct’ and ‘dealing’

We note the defined term ‘retail product distribution conduct’ includes financial product advice but excludes personal financial advice. ISA will provide further comment on this below.

Schedule 1, subparagraph 994D(c)(ii)

We understand that there will be situations where it will be difficult for a distributor to establish if the issuer has made a target market determination. However, rather than establishing a defence for the distributor and basing it on a reasonableness test, it may be more in keeping with the policy intent of the DDOs to make the issuer establish an attestation or certificate of currency of the target market.

Schedule 1, subsections 994E(1) and (2) ISA strongly objects to this change. The policy intent of DDOs is to make the issuer responsible for distribution decisions and to supervise and take an active role in distribution, regardless of whether distribution occurs in-house (for example, within vertically integrated wealth management) or through third parties. The draft approach is likely to create a risk management incentive for issuers to deal in third parties, so as to avoid liability for distributing to the non-target market.

## 1.4 Distributor Obligations – Personal Advice

Schedule 1, subsection 766B(3A) ISA has for many years noted that how much an issuer knows and asks about a client (and whether this constitutes personal advice) has been used as an excuse to argue the issuer may be inadvertently giving personal advice. “We can’t do that because it will become personal advice” has regularly been given as a reason for not implementing particular FOFA reforms. It has previously been used as an excuse in regards to changes to general advice, scaled advice, and calculators at various times. ASIC has previously taken a more facilitative interpretation of ‘know your client’ in its regulatory guidance on the Best Interest Duty and on examples of intra fund and scaled advice. ISA is not convinced an amendment to the personal advice definition is required to establish that information required for a market determination does not constitute personal advice.

Having said that, the amendment does not undermine the intent of the definition of personal advice. It simply provides further evidence that there has been significant and successful lobbying by those wishing to dilute the DDOs.

Schedule 1, subsection 994A(1), definition of ‘excluded conduct’, paragraph 994D(d) subsections 994E(1) and (3), paragraph 994G(b) and subsection 994J(2) The dilution of this provision seems to have been driven by significant lobbying by a retail financial advice sector which has featured prominently in the Royal Commission. It is not clear to us why the design and distribution obligations cannot sit alongside an adviser’s obligations to act in clients’ best interests. One is in relation to a class of investors, the other is in relation to an individual’s personal financial circumstances. The scope is different, and personal advice is a critical distribution channel. Consumers would expect advisers to be subject to the same obligations as the issuer – particularly where the adviser is giving personal advice from within a vertically integrated financial institution.

## 1.5 Distributor Obligations – Non-Target Market Consumers

Schedule 1, subsection 994E(4)

In effect the distributor does not breach the DDOs if customers outside the target market determination are present, provided reasonable steps are taken (involving a risk management approach). This could effectively lead to significant dilution of the provisions. ‘Reasonable steps’ will need to be clearly defined otherwise this will undermine the obligations, with distributors potentially seeking to establish a set of a light touch reasonable steps, in form, rather than any substance.

## 1.6 Issuer and Distributor Obligations – Record-Keeping Requirements

Schedule 1, paragraph 994B(5)(h) subsections 994B(6) and (7), and subsection 994F(1)

Given the current sophistication of record keeping systems it is not clear to ISA why there would be a significant regulatory burden. If the record keeping is intended to become scalable then there must be penalties for not having sufficient information.

We note the need for anti-avoidance measures here in interaction with a deliberately broad target market determination. There may be a temptation to define a broad target market and keep minimal record keeping from a litigation perspective. This would unfortunately severely limit the effectiveness of the DDOs.

Schedule 1, subsections 994F(1) to (4)

No commentary on this change.

## 1.7 Issuer Obligations – Reviews

Schedule 1, subsections 994C(4), (5) and (7)

No commentary.

Schedule 1, subsections 994C(3) and (4)

No commentary.

## 1.8 Issuer and Distributor Obligations – Notification of ASIC

Schedule 1, section 994D

No commentary.

## 1.9 Issuer and Distributor Obligations – Consequences and Penalties

Schedule 1, section 994M

No commentary.

### About Industry Super Australia

Industry Super Australia is a research and advocacy body for Industry SuperFunds. ISA manages collective projects on behalf of a number of industry super funds with the objective of maximising the retirement savings of over five million industry super members. Please direct questions and comments to:

**Dr. Nick Coates**  
**Head of Research and Campaigns**

[REDACTED]

[REDACTED]

ISA Pty Ltd ABN 72 158 563 270 Corporate Authorised Representative No. 426006 of Industry Fund Services Ltd  
ABN 54 007 016 195 AFSL 232514