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D and D for beginners: Product design and distribution

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Considering the deluge of regulatory reform bearing down on licensees and advisers, it is not surprising that the product design and distribution obligations have largely been overlooked.

That is a mistake, because although they will not be one of the 'most significant reforms of financial services since the *Financial Services Reform Act 2001*', they will create an environment in which product issuers—and not advisers—will bear primary responsibility for product failures and mis-selling.

That is not to say that licensees and advisers are not also affected, but the best interests duty and related obligations mean that they are spared most of the impact of these changes.

So, although advisers might consider that the design and distribution obligations are largely a matter for the product issuers, they still need to understand their obligations and the scope of the new regime.

In summary, the new regime, which was created by the *Treasury Laws Amendment (Design and Distribution Obligations and Product Intervention Powers) Act 2019*, (Design and Distribution Act):

- encompasses design, issue, distribution, intervention and enforcement
- requires a product issuer to prepare a target market determination (TMD) for each product
- requires a distributor to take reasonable steps to comply with the TMD

- requires a distributor to track, record and escalate any breaches or complaints.

The scope

The revised Explanatory Memorandum to the Design and Distribution Act states:

Although [previous] losses [to consumers from product failures] have a number of contributing causes, poor product design and distribution practices that disregard consumer behavioural biases and information asymmetries played a significant role.

The new product design and distribution regime set out in part 7.8A of the *Corporations Act 2001* commencing on 5 October 2021, will apply to issuers and distributors of financial products. For issuers, the obligations apply to persons who must prepare a disclosure document under the Corporations Act, for example, a responsible entity, an insurer, a superannuation trustee or an issuer of hybrid securities.

For distributors, the obligations apply to anyone engaging in retail product distribution conduct, for example, dealing in a financial product, giving a disclosure document, providing a product disclosure statement or providing financial product advice.

Essentially, the design and distribution obligations impose requirements at each stage of developing and distributing a financial product from product design to product distribution, monitoring and review.

The regime encompasses many of the financial products with

which advisers may deal, but it specifically excludes:

- MySuper products
- margin lending facilities
- securities that have been or will be issued under an employee share scheme
- fully paid ordinary shares in a company or a foreign company
- financial products issued, or offered for regulated sale, by an exempt body or an exempt public authority
- financial products of a kind prescribed by regulations.

Target market determinations

Perhaps the core of this new regime is the requirement that most, if not all, financial products marketed to retail clients will have a target market determination (TMD)—a written statement from the issuer that confirms the people, or classes of people, for whom the product may be appropriate.

The TMD can be thought of as a less immediately useful movie classification scheme for financial products—except one where the studios classify their own films.

The TMD prepared and maintained by the issuer must:

- describe the class of consumers that comprise the target market for the product
- specify any distribution conditions and restrictions on distribution
- specify review triggers (events that reasonably suggest the TMD is no longer appropriate)
- specify when the first review of the TMD must occur
- specify when subsequent reviews of the TMD must occur
- specify reporting periods stating when distributors should provide information about the number of complaints about the product to the issuer, and
- specify the kinds of information the distributors must report to the issuer (and how frequently).

The issuer's obligations

In the new regime, issuers have a range of obligations beyond developing, administering and marketing financial products. Specifically, they must:

- prepare a TMD for the financial product that meets all the requirements (including the 'content and appropriateness requirements')
- make the TMD publicly available—this applies to both new and continuing products
- take reasonable steps that will, or are reasonably likely to, result in distribution being consistent with the TMD
- review the TMD to ensure that it remains appropriate
- notify the Australian Securities and Investments Commission (ASIC) of significant dealings that are not consistent with the TMD, and
- keep records of the decisions made (including the data and analysis underlying those decisions) in relation to compliance with the design and distribution obligations.

The distributor's obligations

As discussed, anyone providing personal advice is already subject to a range of requirements, obligations and prohibitions (including appropriateness of advice, the best interests duty and client priority) that govern their conduct in respect of product distribution.

For this reason, advisers are broadly—but not entirely—excluded from the more onerous requirements of the regime. That is not to suggest that they are entirely spared, because their authorising licensees assume additional obligations that inevitably trickle-down to impact their representatives.

For example, licensees must take reasonable steps to:

- ensure that their product distribution methods—marketing, promotion and recommendations—reflect, and are consistent with, the most recent TMD for that product
- notify an issuer as soon as practicable (or within 10 business days) if they become aware of a significant dealing in the product that is not consistent with the TMD, and
- keep complete and accurate records of distribution information (including the number of complaints received about a product and information specified by the issuer in the TMD).

Licensees will need to incorporate these additional requirements into their compliance framework and, consistent with the nature, scale and complexity of their business, reflect them in their approach to adviser monitoring and supervision.

If this appears to be a passive obligation, take the time to appreciate that licensees have an ongoing obligation to ensure their distribution method is appropriate. In ASIC's view, this means a governance framework that regularly considers:

- its compliance with the issuer's conditions
- its distribution method
- its marketing and promotional materials
- the effectiveness of product governance and distribution oversight
- the appropriateness of any 'sales' incentives
- the training provided to its representatives, and
- the target market determinations.

Compliance considerations

In preparation for the new regime advisers may wish to consider the following aspects of their businesses:

- Review of approved product lists and research methodology
- Incorporation of the consideration of the TMD into the advice process
- Review of monitoring and supervision frameworks
- Review of marketing and promotion guidelines
- Review of risk appetite, and
- Training of advisers and support staff.

The sticks

The revised Explanatory Memorandum to the Design and Distribution Act states:



The quote

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The combination of civil and criminal penalties allows ASIC or the prosecutor (as the case may be) to take a proportional approach to enforcing the new obligations.

While these reforms may not significantly impact advisers or their advice processes, advisers should not underestimate either their obligations to comply or the significant costs of non-compliance.

Non-compliance can result in penalties for contraventions ranging from \$11,100 to \$44,000 for individuals, and \$55,000 to \$222,000 for corporations. In addition, some contraventions can attract penalties of imprisonment for terms from 12 months to five years.

Product intervention

There is not much licensees or advisers can do about this beyond acknowledging that, since April 2019, ASIC has had the power to proactively and pre-emptively intervene in respect of financial and credit products that risk causing significant detriment to consumers, or are 'misaligned with their needs, understanding or expectations'.

In practical terms, where ASIC considers that a financial product or a class of financial products may be mis-sold, misrepresented or cause significant detriment, ASIC can make:

- an individual order that applies to a specific person(s) in relation to a product, or
- a market-wide order that is applicable to a person in relation to a class of product.

If this seems to be a broad power, it is, and necessarily so, and it is not a theoretical risk but a power that ASIC has not hesitated to use.

For example, in September 2019 ASIC made its first product intervention order in respect of short term credit to protect consumers from predatory lending. Although challenged, this intervention was subsequently upheld by the Federal Court. In a media release of 15 April 2020, ASIC Commissioner, Sean Hughes stated:

We are pleased today's judgment upheld our intervention order and the consumer protections it is designed to deliver. We will continue our efforts to protect vulnerable consumers, particularly during this time when significant numbers of people are facing uniquely challenging circumstances. We will move swiftly where we see high cost products that seek to exploit the day-to-day immediate needs of financially vulnerable consumers.

Broadly speaking, before intervening ASIC will consider:

- the nature and extent of the detriment or likely detriment
- the actual or potential financial loss to retail clients
- the impact that the detriment will have, or will or is likely to have on retail clients
- any other matter. **FS**