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# DESIGN AND DISTRIBUTION OBLIGATIONS

Practical guidance for implementing DADO

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**T**he design and distribution obligations (DADO) have commenced and must be implemented by April 2021. So what exactly do financial product developers and distributors need to be aware of? What metrics and other indicators need to be developed to monitor these new requirements? This paper looks at the new obligations and provides some guidance on what needs to be considered in terms of implementing DADO.

## Overview

The design and distribution obligations (DADO) were enacted by the *Treasury Laws Amendment (Design and Distribution Obligations and Product Intervention Powers) Act 2019*, which amends the *Corporations Act 2001*, the *National Consumer Credit Protection Act 2009* and the *Australian Securities and Investments Commission Act 2001* (the ASIC Act). The new regime applies to financial products (including consumer credit), as defined under the *Corporations Act 2001*.

The new laws commence on 5 April 2021 (for DADO); the product intervention powers have already commenced.

### Key obligations for product issuers:

- prepare a Target Market Determination (TMD), which meets minimum requirements
- formulate metrics and other indicators to identify when a review trigger or another event or circumstance has arisen that indicates that the TMD may no longer be appropriate
- distribute products consistently with the TMD

- notify ASIC of significant dealings that are inconsistent with the TMD.

### Key obligations for product distributors:

- distribute products in accordance with the TMD prepared by the issuer
- provide information to product issuers
- notify product issuers of significant dealings that are inconsistent with the TMD.

## What is DADO?

On 5 April 2019 the *Treasury Laws Amendment (Design and Distribution Obligations and Product Intervention Powers) Act* received Royal Assent. The product intervention powers have already commenced and the Australian Securities and Investments Commission (ASIC) has already exercised its powers under this regime. The design and distribution obligations (DADO) have an extended implementation period and will commence on 5 April 2021.

DADO is a set of obligations that require product issuers to define a target market for their products and ensure the product issuer and any third party distributors, sell and distribute the product in a manner which is consistent with the defined target market. It is designed to address the end-to-end product cycle and perceived gaps or failings in the current regulatory environment to protect consumers from harm resulting from poorly designed products or mis-selling.

## Application of DADO

The DADO laws apply to financial products where disclosure is required under Part 6D.2 or a product disclosure statement under Part

7.9 of the *Corporations Act 2001*. The obligations also apply to the expanded definition of ‘financial product’ under the ASIC Act, which includes credit facilities. The expanded scope of the regime to include the definition of financial product under the ASIC Act was introduced in subsequent drafts of the legislation. In a submission made by ASIC on the Bill, ASIC called for the inclusion of credit products and other products that are only regulated by the ASIC Act.

With respect to credit, ASIC considered responsible lending obligations afforded protection to particular individual transactions whereas DADO applies to the entire product lifecycle.

Draft regulations have also been released for comment which further extend in-scope products to include basic banking products (amongst other specified financial products) and excludes a range of financial products that are considered should fall outside of the regime such as medical indemnity insurance, credit provided for business purposes and mortgages.

Under the amendments, ASIC also now has a product intervention power under both the *Corporations Act 2001* and *National Consumer Credit Protection Act 2009* to prevent or respond to significant consumer detriment and to make consequential amendments under the ASIC Act.

As noted, the product intervention powers have already commenced and therefore this paper focuses on implementation of DADO which is set to commence in 2021.

## The purpose of DADO

The DADO and related product intervention powers emerged as part of the government’s response to the 2015 Financial System Inquiry (FSI). The FSI identified that while there have been significant reforms in consumer protection laws since the global financial crisis, more was needed to better align consumer outcomes with commercial objectives throughout the entire product cycle.

As many recent cases and the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry have shown, poor product design or mis-selling can have significant detrimental impacts on customers. Examples of these outcomes have been evident in the distribution of certain types of insurance products, such as the distribution of funeral insurance to vulnerable customers and poorly designed or poor selling practices in connection with consumer credit insurance. ASIC has also highlighted the potential for mis-selling of basic products such as selling high features, high fees transaction accounts to customers who may only require a simple, low feature account and issues identified with the mis-selling of term deposits.

The Explanatory Memorandum (EM) to the DADO legislation acknowledges that consumer protection in the design and distribution of financial products has historically relied on disclosure as a key measure to protect consumers. Disclosure has long been considered to fall short of achieving its outcome for a variety of reasons. The EM

explains that content in documents such as product disclosure statements (PDS) has become benign for many consumers who tend to gloss over the detail or the PDS itself lacks sufficient clarity or quality content to convey key messages resulting in disengagement by consumers. The EM also highlights that these weaknesses and others, such as low financial literacy, are creating a barrier to understanding and a lack of desire or availability of financial advice for certain financial products.

DADO is intended to assist consumers to make better decisions to acquire financial products by ensuring product issuers and distributors have a ‘customer-centric approach’ to designing, marketing and distributing financial products.

In addition to the increasing intensity of the regulatory environment, in our view, sound product governance is good business practice not only to ensure that you ethically distribute a product but also design a product that genuinely delivers value and satisfies needs. This not only increases regulatory compliance but has the potential for more meaningful, long-term relationships with customers.

## Key obligations under DADO

There are a number of detailed obligations that require careful consideration. The obligations either apply to product issuers or distributors. Some of the key obligations are summarised below.

### For issuers

- performance of a Target Market Determination (TMD) for all ‘in-scope’ products
- TMD must comply with minimum requirements (including setting review triggers and distribution conditions)
- TMD must be available to the public free of charge
- TMD must be periodically reviewed
- obligations to cease product distribution within 10 business days upon certain events occurring (unless it is determined that the TMD remains appropriate)
- record keeping obligations for: target market determinations for the product; review triggers; review periods; requirements for TMDs; distribution in accordance with TMD
- notification to ASIC requirement—significant dealings that are inconsistent with the target market determination.

### For distributors (regulated persons)

- must make reasonable inquiries to form a belief on reasonable grounds that a TMD has been made, the financial product does not require a determination or the product is excluded
- reasonable steps to distribute a financial product in accordance with target market determination
- record keeping of distribution information
- reporting information to product issuers within 10



### The quote

*It is designed to address the end-to-end product cycle and perceived gaps or failings in the current regulatory environment to protect consumers from harm resulting from poorly designed products or mis-selling.*

business days (complaints and significant dealings that are inconsistent with the target market determination).

As the amendments do not come into effect until 5 April 2021, it is easy to be lulled into thinking that there is time to prepare. However, upon closer examination of the obligations, there could be a lot of work involved, particularly if DADO is to be implemented with the spirit and intent of the new laws. It is also important to note that civil and criminal penalties apply to contraventions of the new arrangements which are linked to the higher penalties now available under the *Corporations Act 2001*.

### A guide to DADO implementation

Based on our interpretation of the requirements, if you are yet to commence implementation of DADO, now is the time to get started in developing a plan for implementation. In addition to performing a TMD for each in-scope financial product, there a number of key distribution requirements, ongoing monitoring and other supporting processes that need to be developed. These can take some time, particularly when considered in the context of the broader regulatory change agenda for 2020.

#### Assessing what is captured

The first step to implementing DADO will be to assess financial products issued or distributed by the entity to determine if they are in scope and require a TMD. As set out above, DADO broadly applies to financial products; however there are some specific inclusions and exclusions that will require consideration.

Financial products captured by the regime include:

#### Category 1

Financial products as defined under section 761A of the *Corporations Act 2001*, where disclosure is required under the Act under Part 6D.2 (prospectus) or Part 7.9 (PDS).

Under the applicable sections, a PDS is required to be given when a person recommends or issues a financial product to a retail client. A PDS is not generally required when a sale occurs by a person who acquires the product at or after its issue save for where a PDS is required to be given in sale situations which could otherwise be used to avoid the requirement to give a PDS. Some of the financial products that are likely to fall within this category include:

- general insurance
- term deposits
- investment products.

#### Category 2

Financial products as defined under the ASIC Act (that are not otherwise captured under the Corporations Act definition) where the product is issued to a retail client or the person sells the product under a regulated sale. Financial products that will fall within this category include credit facilities (loans) to consumers.

#### Other categories of financial products

The obligations also apply to those products that require disclosure to investors under Chapter 6D (Fundraising). Chapter 6D.2 of the Corporations Act details when an offer of securities requires disclosure. Generally, issues of securities require disclosure unless an exemption applies.

#### Exclusions

Certain financial products that may otherwise fall within the above categories have been expressly excluded from the regime, such as:

- MySuper products
- margin lending facilities
- securities issued under an employee share scheme
- fully paid ordinary shares.

The regime can also be extended to apply to any financial product prescribed by the Minister in regulations. The revised EM to the Act states that it is the government's intention to prescribe certain financial products which do not presently require disclosure as being captured by the obligation. Draft regulations have been released that further extend in-scope products and clarifies those products that are out of scope. One notable inclusion in the draft regulations are basic banking products that would otherwise be excluded from the regime under the current definitions.

It is important to note that anti-avoidance provisions have been included in the regime to ensure that it applies in circumstances where an entity may otherwise seek to disguise their products to circumvent the regime.

Hence, while at first glance the DADO regime would seemingly apply to clearly defined types of financial products, entities will need to examine the types of financial products and specified inclusions and exclusions in order to identify those products which fall within the regime. For some entities, a comprehensive and technical analysis of products and the application of the new regime and relevant disclosure obligations under the Corporations Act may be required.

#### Implementation tip

A robust process for assessing products will be required to ensure that all relevant products are captured in product governance arrangements. This analysis needs to be documented and appropriate records held for due diligence purposes.

#### Performing product design and target market determinations

The primary obligation under the regime is the requirement for product issuers to perform a TMD. The TMD must comply with minimum requirements that specify that the determination must:

- be in writing
- be made available to the public free of charge
- describe the class of retail clients that comprises the target market for the product
- specify any conditions and restrictions on retail product distribution conduct in relation to the product (distribution conditions)
- specify events and circumstances (review triggers) that would reasonably suggest that the determination is no longer appropriate
- specify the maximum period from the start of the day that a review of the determination is finished to the start of the day that the next review of the determination is to finish
- specify a reporting period for reporting information about the number of complaints about the product
- specify the kinds of information needed to enable the person who made the TMD to identify promptly whether a review trigger for the determination, or another event or circumstances that would reasonably suggest that the determination is no longer appropriate, has occurred
- specify the regulated person or regulated persons that are required

to report the information to the person who made the determination

- specify a reporting period for reporting information to a person who made the determination.

While further clarity on this requirement is hoped to be provided in ASIC's regulatory guidance (yet to be released), given the close resemblance the Australian regime has to the product governance regime in other jurisdictions, further guidance and insights on how to approach a TMD may be drawn from overseas examples and guidance.

Some common themes emerge when looking at approaches from overseas. In particular, TMDs tend to focus on the following categories:

- client type
- characteristics
- needs and objectives
- risk profile.

According to the Australian regime, the TMD must also specify review triggers and distribution conditions. Given the requirement to make the TMD publicly available, it will need to be carefully drafted to ensure that it meets the minimum requirements set out in the new provisions but is also achievable for the issuer and distributor to maintain.

#### Implementation tip

A robust process for developing and maintaining target market determinations will be required. Organisations could start mapping key features and characteristics of each of their products against broad categories such as those listed above while awaiting further ASIC guidance.

#### Ensuring distribution according to a target market

There are two key requirements that will generate a need to monitor distribution of financial products:

- the obligation to review a TMD where a review trigger or other event or circumstance arises which suggests that the TMD is no longer appropriate (this applies to both issuers and distributors)
- the obligation to take reasonable steps to ensure that the product is being distributed in a manner consistent with the TMD (this applies to issuers only).

Financial services institutions will need to develop appropriate criteria (which may consist of metrics and other indicators) to ensure compliance with these obligations.

#### What is a review trigger?

A review trigger is defined as an event or circumstance which would reasonably suggest that the determination is no longer appropriate. The most obvious indicator therefore that could be used as a review trigger would be high levels of complaints relating to the design or distribution of a particular product. However, complaints are lag indicators where detriment may have already occurred. In our view, further measures, such as lead indicators, will need to be developed to mitigate the risk of contravening DADO, but to also mitigate the risk of compensation being payable to customers that may arise as a result of poor design or mis-selling of a financial product. By way of illustration, a potential lead indicator for a deposit/transaction accounts may be high levels of inactive accounts; for insurance products it may be low levels of claims, or for credit products disproportionate levels of early termination/refinancing or high arrears or hardship.

#### Implementation tip

As far as possible, a TMD should be based on objective criteria that will assist with defining review triggers, events and circumstances and other information for monitoring distribution practices.

#### Consequential changes to internal processes and practices

In addition to implementing new measures to meet DADO, there are likely to be a number of consequential changes to existing processes, systems and contractual documentation to effectively implement the obligations. At a minimum, it was anticipated by the government when proposing the new regime that distribution agreements with third party distributors may need to be reviewed or amended to ensure appropriate controls are implemented by the distributor. Some possible examples of controls that were recommended by the government that might be considered for distribution arrangements include:

- targeted disclosure—providing information about the TMD, such as targeted warnings at key decision making points
- ensuring information is delivered to distributors, such as scripts and other selling guidelines
- tools to help consumers understand/decide, such as calculators, case studies
- requiring choice—positive action rather than distribution by default
- staff competency—ensure that staff sufficiently understand the products they are selling
- managing conflicts, particularly those arising with customers
- supervision of selling and distribution practices
- using customer information to conduct assessments on the appropriateness of the product for a particular customer.

Requirements for information reporting, record keeping and monitoring distribution may also need to be considered in distributions agreements with third party distributors.

#### Recommended next steps

- analyse obligations, products and distribution of products (which may include rationalisation of duplicated products or archiving legacy products)
- develop an implementation plan
- raise awareness with internal and external stakeholders
- develop or review key record-keeping processes and templates
- commence product assessments to begin defining target markets for each in-scope financial product. **FS**