THE UNIVERSITY OF
NEW SOUTH WALES

FACULTY OF LAW

DIMITY KINGSFORD SMITH
PROFESSOR
School of Law

Ms Diane Brown
Chief Adviser at Financial System Division,
The Commonwealth Treasury.
By Email: Brown, Diane Diane.Brown@TREASURY.GOV.AU

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Dear Diane,

Design and Distribution Obligations and Product Intervention Power: Proposals Paper

Thank you for agreeing to consider this response to the above paper so very late. I hope it remains helpful, and is worth the wait. As I imagine you have greatly progressed the work on this topic, I have kept the response short, and targeted at areas where I think there is most to be contributed.

In answer to many of the questions raised in the proposal, along with Dr Marina Nehme, I have in a sense 'already had my say'. So I refer you and your colleagues back to the paper we wrote for Treasury in April 2015, and which was sent on to you by the ASIC Consumer Advisory Panel. For ease of reference it is here:
https://clmr.unsw.edu.au/sites/default/files/product_intervention_powers_final_2April2015_Kingsford_Smith_and_Nehme.pdf
Likewise, I attach a paper which has been accepted for publication in the *Handbook of Research on International Consumer Law and Policy* a long-standing work which charts departures in research and thinking in the consumer area and reports on them about every 5 years. There, along with Dr Olivia Dixon, I do some analysis of design and distribution obligations and product intervention powers. There are points in this piece too, which go to the answers to some of your questions.

Responses to the Questions in the Proposal Paper

The Range of Products Covered by the Measures

1. *Do you agree with all financial products except for ordinary shares being subject to both the design and distribution obligations and the product intervention power?*

   Yes. In the legislation 'ordinary shares' should be defined with some care, so the category cannot become a 'regulatory arbitrage' opportunity. For example, the definition should be limited to fully paid ordinary shares of ASX 200 listed companies. Exchange Traded Funds as a further example should not fall within the definition of 'ordinary shares'. There should be no opportunity for artful design of instruments that in form are ordinary shares and in

SYDNEY 2052 AUSTRALIA
Email: .kingsfordsmith@unsw.edu.au
Telephone: +61 (2) 9385 2245
Facsimile: +61 (2) 9385 1175
Location: Law Building, Room 314
Enter Gate 2 High St, Kensington

substance are the complex or structured products that it is intended (amongst others) this initiative will protect retail investors in relation to.

For abundant clarity, as super is a core investment product in Australia (as mortgages are core credit products) it should be included. Super is compulsory and heavily subsidised by foregone tax revenue: interests in it should definitely be included. As a final point, any definition of financial product or its distribution which may become subject to the proposals being commented on here, must include those which depend on software programs and other digital features.

2. *Do you agree with the design and distribution obligations and the product intervention power only applying to products made available to retail clients?*

   These approaches should also apply to credit and financial products commonly used by small business. It should also be made clear that they apply to super funds should they use a corporate trustee.

   In the UK and EU intervention is available where a product may cause systemic instability. This recognises that products and practices in the wholesale markets, can cascade into retail markets (and indeed, across the financial system). This is a strong argument for a wider approach being taken in Australia as well especially in relation to the protection of the core retail financial products such as super and mortgage credit. It is unlikely that product intervention powers will be often used, but where other regulatory strategies and consultation have failed, they could prevent serious disruption to the system, and financial loss. The inter-connected nature of markets (including wholesale and retail) is well established, and the GFC provides recent evidence of this phenomenon.

3. *Do you agree that regulated credit products should be subject to the product intervention power but not the design and distribution obligations?*

   No. 'Responsible lending' obligations are to individuals and (usually) require individual action to seek redress for breach. 'Responsible lending' goes more to the conduct of distributors (can the borrower afford the loan?) such as mortgage brokers, rather than the role of issuers. Design and distribution obligations and product intervention are scale regulatory strategies across sectors or markets. They are *regulator's actions* in response to systemic design (issuer obligations) and distribution (issuer if direct/and advisers and brokers if intermediated) deficiencies. They address the mass market nature of retail financial markets, and the inadequacy of existing individual remedies to address the potential for harm in wide-spread products. Responsible lending obligations are also ex post, where as those being commented on here are pre-emptive.

   Further, responsible lending has no traction on product design. Nor has it any grip on the targeting (in distribution) of populations or markets which are unlikely, as a socio-economic matter, to obtain benefit from the credit product sold. The sale of 'teaser loans' (where interest rates jump beyond affordability after a short period) is an example of design matters outside 'responsible lending' obligations. The targeting of indigenous communities with consumer leases, pay-day loans or pawn agreements is an 'at scale' example of conduct leading to detriment in groups for whom there is little consumer benefit. Finally, it makes common sense that departure from design and distribution obligations might be an evidence point in deciding whether there is sufficient consumer detriment to use a product intervention power. It seems counter-productive to make ASIC's enforcement work job more difficult by excluding credit from basic product governance.

4. *Do you consider the product intervention power should be broader than regulated credit products? For example, 'credit facilities' covered by the unconscionable conduct provisions in the ASIC Act. If so, please explain why with relevant examples.*

   Yes. As elaborated in our 2015 paper, limiting the coverage of particular segments, providers or products, opens the doors to 'regulatory arbitrage'. There are plentiful examples of this in the history of securities and financial regulation where form is elevated over function in an effort to fit within exemptions or exclusions. These are usually justified on the basis of allowing or not quelling innovation. Very often the supposed innovation is nothing more than moving around the rights and obligations of an instrument to have it characterised formally as outside the technical reach of regulation, regardless of its financial function and the beneficial purpose of the regulation.

   Design and Distribution Obligations

5. *Do you agree with defining issuers as the entity that is responsible for the obligations owed under the terms of the facility that is the product?*

   Yes. This definition should be as inclusive as possible, to avoid the temptation for regulatory 'arbitrage' or work arounds as described in the response to the last question. The question leaves open the treatment of off-shore issuers and distributors, perhaps a topic for another day, but one which the proposals here do not really examine. If it is not possible to consider this jurisdictional dimension now, it should be on the list for the review of the reforms in 5 years' time. This off-shore dimension is particularly pertinent in insurance.

6. *Do you agree with defining distributors as entity that arranges for the issue of a product or that:*

   (i) *advertise a product, publish a statement that is reasonable likely to induce people as retail clients to acquire the product or make available a product disclosure document for a product; and*

   (i) *receive a benefit from the issuer of the product for engaging in the conduct referred to in (i) or for the issue of the product arising from that conduct (if the entity is not the issuer).*

   Yes. As with the answer to the prior two questions, this definition should be as inclusive as possible to avoid attempts to avoid the regulation. It is also helpful to carefully extend existing Corporations Act definitions, to make the transition period for these proposed additional responsibilities as easy as possible for industry and for regulatory consistency.

7. *Are there any situations where an entity (other than the issuer) should be included in the definition of distributor if it engages in the conduct in limb (i) but does not receive a benefit from the issuer?*

   Again, a uniform treatment of issuers and distributors is desirable for regulatory compliance and enforcement. As the fees charged by Storm Financial demonstrated, even when customers pay providers directly, they may still need protection.

8. *Do you agree with excluding personal financial product advisers from the obligations placed on distributors? If not, please explain why with relevant examples. Are there any other entities that you consider should be excluded from the definition of distributor?*

   The arguments made above in answer to 3 about the proposals considered here being scale regulatory strategies across sectors or markets and not about obligations owed to

individuals apply here. Financial adviser obligations are owed to and must (usually) be enforced by individuals, they likewise have no traction on product design and distribution to 'target markets' at scale. It misses the regulatory target to think that financial advisory obligations already in place can be a substitute for the proposals under consideration here.

9. *Do you agree with the obligations applying to both licensed and unlicensed product issuers and distributors? If they do apply to unlicensed issuers and distributors, are there any unlicensed entities that should be excluded from the obligations (for example, entities covered by the regulatory sandbox exemption)? Who should be empowered to grant exemptions and in what circumstances?*

   Yes. As with the answer to previous questions, the application of the regulation should be as inclusive as possible to head-off attempts to avoid it. Indeed, there is good reason in practice and policy to include in the proposed legislation an 'anti-avoidance' provision for these reasons.

10. *Do you agree with the proposal that issuers should identify appropriate target and non-target markets for their products? What factors should issuers have regard to when determining target markets?*

    As discussed in our 2015 paper, and the attached forthcoming journal article, we largely agree with the factors that have been developed by the FCA in the UK and by the EU policy makers. We emphatically consider that the most important of these factors is the ability of the average individual in the 'target market' to bear the loss commonly associated with the financial product being offered. From the consumer perspective, this is the measure of product risk. The ability to bear loss by the 'target market' should be researched and stress-tested heavily and disclosed to the consumer in limpidly clear terms. Our one additional but salient contribution, is to argue that factors which help identify the target market for 'core' financial products (such as mortgages and super) might be listed in ASIC regulatory guidance (or possibly in the legislation) to stop providers from asserting their 'target market' is so wide, that it is effectively targeted to any financial consumer.

11. *For insurance products, do you agree the factors requiring consumers in the target market to benefit from the significant features of the product? What do you think are significant features for different product types (for example, general insurance versus life insurance)?*

    Yes. A considered answer to the second limb of this question will require specialised insurance legal and regulatory knowledge.

12. *Do you agree with the proposal that issuers should select distribution channels and marketing approaches for the product that are appropriate for the identified target market? If not, please explain why with relevant examples.*

    Yes. As per the discussion in the attached forthcoming journal article, we think this should be in close collaboration with the distributors, since they will often have more information about the consumers constituting the 'target market'.

13. *Do you agree that issuers must have regard to the customers a distribution channel will reach, the risks associated with a distribution channel, steps to mitigate those risks and the complexity of the product when determining an appropriate target market? Are there*

any other factors that issuers should have regard to when determining appropriate distribution channels and market approach?

Yes.

14. *Do you agree with the proposal that issuers must periodically review their products to ensure the identified target market and distribution channel continues to be appropriate and advise ASIC if the review identifies that a distributor is selling the product outside of the intended target market?*

    Yes. At least once a year and more often for new products.

15. *In relation to all the proposed issuer obligations, what level of detail should be prescribed in legislation versus being specified in ASIC guidance?*

    The requirement to adopt and operate proper issuer obligations should be in the legislation. So should any sanctions on providers or enforcement options ASIC might need. If the actual standards to be adopted are to be 'principles based' then issuers might be given the option to adopt those of their industry association, or those to be issued by ASIC.

16. *Do you agree with the proposal that distributors must put in place reasonable controls to ensure that products are distributed in accordance with the issuer's expectations?*

    Yes.

17. *To what extent should consumer be able to access a product outside of the identified target market?*

    Consumers may access products outside the target market, so long as they are aware that is what they are doing. Before accessing a product outside the target market the consumer must be made aware of the likelihood, nature and extent of loss they may suffer, and how that compares with their ability to bear loss. The current legislation allows a concentration on the benefits a product *may* deliver and specifies very little at all about how and which risks should be communicated. In particular, there is no requirement in the legislation (though there likely is a requirement in negligence if advising) to assess whether the customer can stand the likely loss should it eventuate. This needs to be conveyed otherwise consumers will not be able to judge the practical significance of their decision to their own finances, if they leave the target market.

18. *What protections should there be for consumers who are aware they are outside the target market but choose to access a product regardless?*

    The most important aspects are set out in response the prior question.

19. *Do you agree with the proposal that distributors must comply with reasonable requests from the issuer related to the product review and put in place procedures to monitor the performance of products to support the review? Should an equivalent obligation also be imposed on advised distributors?*

    Yes to both the above questions which comprise question 19.

20. *In relation to all the proposed distributor obligations, what level of detail should be prescribed in legislation versus being specified in ASIC guidance?*

    The principles in the answer to question 15 above in relation to issuers, should also apply to distributors.

Product Intervention Power

21. *Do you agree with the obligations applying 6 months after the reforms receive Royal Assent for products that have not previously been made available to consumers? If not, please explain why with relevant examples.*

    Yes.

22. *Do you agree with the obligations applying to existing products in the market 2 years after the reforms receive Royal Assent? If not, please explain why with relevant examples and indicate what you consider to be a more appropriate transition period.*

    Yes.

23. *Do you agree that ASIC should be able to make interventions in relation to the product (or product feature), the types of consumers that can access a product or the circumstances in which a consumer can access the product If not, please explain why with relevant examples.*

    Yes. The legislation should privilege the ability of ASIC to make interventions in relation to 'core' products - as already mentioned an example of core products might be mortgage credit or super.

24. *Are there any other types of interventions ASIC should be able to make (for example, remuneration)?*

    Yes. Remuneration should be a factor taken into account in identifying the 'target market' as part of product governance. See short discussion of this in the attached forthcoming article. It will likely also be an aspect of evidence collected and weighed in determining 'likelihood of significant detriment' as a prelude to intervening.

25. *Do you agree that the extent of a consumer detriment being determined by reference to the scale of the detriment in the market, the potential scale of the detriment to individual consumers and the class of consumers impacted? Are there any other factors that should be taken into consideration?*

    Yes. The other critical factor in determining consumer detriment, is not just the 'scale of the detriment [or losses] to individual consumers' but the ability of members of the 'target market' *to bear the losses* associated with the product. As anticipated in answer to other questions above, this is particularly important in relation to 'core' financial products.

26. *Do you agree with ASIC being required to undertake consultation and consider the use of alternative powers before making an intervention? Are there any other steps that should be incorporated?*

Yes. However, to avoid such consultations being prolonged, there should be a statutory limit on how long they can last – say 12 months. Further, as in the UK in limited circumstances of great market disruption and urgency, ASIC should have an exceptional power to act without consultation. These circumstances should be outlined in the legislation.

27. *Do you agree with ASIC being required to publish information on intervention, the consumer detriment and its consideration of alternative powers? Is there any other information that should be made available?*

    Yes. There should be no requirement on ASIC to use alternative powers, but it should be able to prove that it has considered these other powers except in circumstances of great market disruption of the type and for the reasons described in answer to the prior question.

28. *Do you agree with interventions applying for an initial duration of up to 18 months with no ability for extensions? Would a different time frame be more appropriate? Please explain why.*

    No. The intervention should stay in place until ASIC and the Government are satisfied that arrangements have been made (by agreement, by legislation, by training etc) to remove the source of likely consumer detriment.

29. *What arrangements should apply if an ASIC intervention is subject to administrative or judicial appeal? Should an appeal extend the duration that the Government has to make an intervention permanent?*

    This is one reason for the answer given above to question 28. It is simply impossible to predict how long it will take to remove the source of likely consumer detriment. Administrative review and judicial appeals are only one factor in that process.

30. *What mechanism should the Government use to make interventions permanent and should be mechanism differ depending on whether it is an individual or market wide intervention? What (if any) appeal mechanisms should apply to a Government decision to make an intervention permanent?*

    The mechanism adopted should match the nature of the case. If the failing to be addressed is wide-spread in the financial sector (such as perverse incentives form remuneration models) this should be dealt with by legislation. From legislation the only additional challenge would be a constitutional one. If the failing to be addressed is less controversial, thorough-going and involves fewer rights, then a statutory instrument or ASIC guidance may be sufficient. In short, the response which allows ASIC and the Government to be confident that the detriment to consumers has been addressed, should be decided on the usual regulatory principles that apply to all other financial sector regulation.

31. *Are there any other mechanisms that could be implemented to provide certainty around the use of the product intervention power?*

    I expect these will become evident through use of the power and can be returned to at the time of the legislative review of the powers 5 years from Royal Assent.

32. Do you agree with the powers applying from the date of Royal Assent? If not, please explain why with relevant examples.

    Yes.

Enforcement and Consumer Redress

33. *What enforcement arrangement should apply in relation to a breach of the design and distribution obligations or the requirements in an intervention?*

    This response considers there should be a legislative obligation on providers to enact product governance. A breach of the design and distribution obligations should be subject to the usual range of regulatory interventions that ASIC might consider for a legislative breach. The most obvious of these might be an exercise of the product intervention power, with enforceable undertakings as another likely possibility. As a breach of a product intervention power is an act unauthorised by the provider's licence, the response should be imposition of a licence condition. This should be accompanied by any other of the usual range of regulatory interventions that ASIC considers appropriate. There is no need to treat breaches of design and distribution obligations or product intervention orders under a special regime. If such a need appears through use of the power it can be addressed in the review of the legislation to be done after 5 years.

34. *What consumer rights and redress avenues should apply in relation to a breach of the design and distribution obligations or the requirements of an intervention?*

    Product intervention powers are regulator's interventions. They are to protect the market including, of course, consumers. They are not intended to give consumers new avenues of redress.
    However, a breach of a product intervention power is conduct unauthorised by the provider's licence. The consumer should be entitled to bring whatever existing action under the legislation or at general law the sale of an unauthorised product allows. If abiding by design and distribution obligations were made an obligation under the statute (see above), a breach of these would give ASIC ample existing measures from which to choose to take action. It is also very likely that a breach of product governance standards or product intervention powers would also be compelling evidence of negligence, or breach of the best interests duty (including in the civil penalties dimension with its extended compensation rights) and other like existing remedies already available to consumers. EDR schemes should be extended by requiring non-licensed providers to become members.
    Thank you again for taking this submission into account, and I am of course happy to receive further questions or queries.

    Yours sincerely,

Dimity Kingsford Smith.