JULY 2018
EXPOSURE DRAFT

Treasury Laws Amendment (Design and Distribution Obligations and Product Intervention Powers) Bill 2018

SUBMISSION

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Industry Super Australia

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

ISA undertakes collective projects on behalf of Industry SuperFunds with the purpose of maximising the retirement benefits of the millions of fund members. We appreciate the opportunity to comment on the July 2018 Treasury Laws Amendment (Design and Distribution Obligations and Product Intervention Powers.

The policy intent of the Design and Distribution Obligations (DDOs) and Product Intervention Powers (PIPs) Bill is sound. However, the proposed manner of execution of that policy intent is unlikely to be successful.

ISA respectfully reiterates the main issue that we previously raised to Treasury on the Bill:

- The removal – from earlier drafts of the legislation – of the requirement for product designers and distributors to define who is not in a product's target market ('target market determination'). Although earlier drafts included this provision, it was subsequently omitted – we understand as a result of lobbying by industry.
- As the legislation stands, product issuers will need only to identify those cohorts for whom the product is appropriate or consistent with objectives, financial situation and needs. It is not clear when a target market determination becomes inappropriate, and while the Explanatory Memorandum alludes to the fact that issuers must test the appropriateness of their determination, the concept is poorly articulated.
- It is possible for product issuers to develop a clear understanding of their non-target market, in addition to determining their target market. All financial products have classes of customers/consumers regarding which there is unsuitability or non-eligibility.
- At times this may be a narrow class of customers – however, risk-flagging their features/characteristics which indicate a lack of suitability is a straightforward proposition using modern analytics. On more complex and opaque products this non-target market may be broader. Nonetheless, the failure to require issuers to determine a non-target market means product issuers may be tempted to define the broadest possible target market to minimise the risk they have populations of customers that do not match the target market. This avoids situations where the target market might become inappropriate, or inappropriately broad.

We will touch on this below, but deletion of non-target market may interact with several new 'scalability' measures in the July 2018 consultation (particularly around scalable record keeping), and set up a range of scenarios where the DDOs can be minimised to the point where effectiveness of these obligations from a consumer protection standpoint becomes questionable. Failure to also determine a non-target market is not desirable and will limit the enforceability of the DDOs. Regrettably, Treasury has proposed no anti-avoidance measures around making the DDO scalable to assist ASIC in preventing this issue arising.

As drafted, ASIC may be unable to use these obligations as part of a broader regulatory approach – instead being limited in their application to isolated instances.

It is likely that the DDO and PIP regime will be released as a policy solution to some of the harm we are currently witnessing at the Baking Royal Commission. The public expectation will therefore reasonably be that this reform is some form of broad product safety regime aimed at protecting them. However, the limitations applied to the regime through the latest rounds of consultation and lobbying will make it very difficult for ASIC to administer these obligations in a way that more broadly protects consumers/investors and instead limits the obligations to outlier products and distribution systems

ISA's interest in the DDOs and PIPs stems from our knowledge of switching and misselling activity in superannuation. While MySuper products are exempted from the DDOs, DDO effectiveness is still important, especially given findings from RiceWarner that most super switching leaves consumers' worse off[1]. 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 the best interest duty.

We will examine whether the addition of a reasonableness concept is sufficient in our comments on the current changes proposed to the drafting.

Finally, ISA notes and supports the inclusion of custodial arrangements for investor directed portfolio services.

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 a 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] 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.

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 reasonability 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 be 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 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:

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