FINANCIAL PRODUCT DESIGN AND DISTRIBUTION OBLIGATIONS

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Late last year the Australian Government released a paper outlining a proposal to implement a range of design and distribution obligations on the issuers and distributors of financial products to retail clients. The proposed obligations are designed to ensure that financial products are targeted at the appropriate consumers. It has now been a few months since the consultation period ended in March. Accordingly, issuers and distributors of financial products to retail clients should start thinking about how the proposals, if implemented, may impact their businesses.

Product issuers

Under the proposal, issuers of financial products to retail clients will be expected to:

- identify appropriate target and non-target markets
- select appropriate distribution channels
- review arrangements to ensure continued appropriateness.

The design and distribution obligations would be imposed on anyone who meets the definition of issuer under the *Corporations Act 2001 (Cth)* (**Act**). The definition of issuer does not depend on whether the person has an Australian Financial Services Licence (**AFSL**) and it is proposed that the obligations will apply to AFSL holders as well as those who are not required to hold an AFSL due to reliance on an exemption.

The scope of entities which will be caught by this definition includes entities such as insurers, banks and trustees of managed funds, but also corporations issuing debentures to raise funds.

The distribution and design obligations are proposed to apply to most products which meet the definition of financial product under the Act. However, ordinary shares are proposed to be exempt as the Government noted that they are widely understood by consumers. Credit facilities other than margin loans are not financial products under the Act and are not proposed to be subject to the design and distribution obligations. Financial products issued to wholesale clients are also not proposed to be subject to the distribution and design obligations.

The Government may consider excluding other financial products depending on whether existing consumer protections already in place in relation to the product are sufficient to negate the need for the design and distribution obligations.

Target markets

Issuers will be required to identify appropriate target markets of consumers and non-target markets. Appropriate target markets would be consumers who would have their needs addressed by the product and who have the ability to understand the key features of the product. For example, individuals close to retirement could be a target market for a guaranteed annuity. The non-target markets would include consumers who would not benefit from the product. For example, the self-employed would be a non-target market for income protection insurance which contains an exclusion for the self-employed. When considering the target market the focus would be on features that consumers pay for, features that will be highlighted in marketing material or features which are unusual.

Issuers of more complex and high risk products may need to do market research to ensure that the target market that they have selected understand the key features of the product. They will also be required to undertake stress testing of the product to assess how it performs in different market conditions.

If the product is intended to be part of a portfolio of products the issuer would be expected to identify how the product is intended to fit in the portfolio, such as through specifying maximum percentages for asset allocation.

Distribution channels

Issuers would be required to select appropriate distribution channels and marketing approaches for the product, taking into account:

- the target market
- the complexity and risk of the product
- the consumers likely to be reached.

For example, the complexity of the product may suggest that the most appropriate distribution channel is financial planners via the provision of personal financial product advice. It was also noted that channels where the consumer can acquire the product without active engagement (such as where consumers are opted-in to a product by default) are unlikely to be appropriate regardless of the target market.

When selecting distributors, the issuer would be required to have regard to:

- the arrangements a distributor has in place to ensure that its representatives have sufficient knowledge and understanding of the product
- the steps taken by the distributor to mitigate the risks that may prevent or limit the product being distributed to the target market
- how the distributor intends to market the product and whether that form of marketing is appropriate for the product.

Distributor obligations

Distributor is not currently a defined term in the Act. The distributor's obligations in the proposal are intended to apply to entities that arrange for the issue of products or influence consumers to acquire the product. However, it is proposed that distribution models where the product is acquired following personal advice will not attract additional obligations.

As with issuers, it is intended that both licensed and unlicensed entities will be caught. This broad definition would capture distributors that provide factual information about the product as well as those that provide general financial product advice.

The issuer must notify the distributors of the target and non-target market for the product. The selected distributor would be required to put in place reasonable controls to ensure that products are distributed in accordance with issuer expectations and controls would be agreed between the distributor and the issuer. A small number of sales outside the target market would not necessarily constitute a breach of the requirement to have reasonable controls in place.

Review arrangements

Once the product has been issued, issuers would be required to conduct periodic reviews to ensure that the target market and the selected distribution channels continue to be appropriate. Review would also be required on an ad hoc basis.

Distributors would also be required to comply with reasonable requests for information from the issuer. Distributors would also be required to put in place procedures to monitor the distribution of the product and collect the necessary data for the issuers review. These types of monitoring activities are currently not typically in place between issuers and distributors unless the distributor is an authorised representative of the issuer.

Issuers would be expected to monitor the products being distributed through each distributor and if significant volumes of the product are being sold to consumers outside the target market the issuer would be expected to raise the issue with the distributor and seek agreement about measures that will be taken to address the matter. Issuers would also be required to report to ASIC if a review identifies that a distributor is selling a product outside of the intended target market and the steps it intends to take in order to address the issue.

Commencement of the reforms

The timing of the commencement of the design and distribution obligations is intended to allow issuers and distributors sufficient time to transition to the new regime.

It is proposed that the design and distribution obligations would apply to new financial products made available to consumers six months after the reforms receive royal assent. Financial products made available to consumers before this period would not have to comply with the design and distribution obligations for a period of two years after the reforms receive royal assent. However, financial products which are closed and do not accept any new applications when the reforms receive royal assent would not be required to conduct periodic reviews at any time.

Conclusion

The design and distribution obligations are intended to work with ASIC's proposed product intervention power to seek fairer outcomes for consumers. From the day after the reforms receive royal assent the proposed product intervention powers would give ASIC the power, where there is a risk of significant detriment to consumers, to make interventions in relation to:

- the product (or product feature);
- which consumers can access the product; or
- how consumers access the product.

The above proposed obligations are intend to decrease the exposure that consumers have to financial products which are not suited to their circumstances. However, it is not currently proposed that issuers would be prohibited from issuing a product to a consumer in the non-target market.

If implemented, the design and distribution obligations will have a significant impact on how financial products are distributed as well as on the traditional relationship between issuers and distributors. Depending on the complexity of the financial products there is also potential to significantly increase the regulatory burden on issuers.

Limited details have been released so far about the design and distribution obligations. However, now that the consultation period has closed it is expected that draft legislation will be released for consideration by mid-2017.
