Corporate Law Workshop 2018

Design and distribution obligations and product intervention powers

Ashley Black

Judge of the Supreme Court of New South Wales

Background to the design and distribution obligations

The regulatory regime for the issue and distribution of financial products under the *Corporations Act* 2001 (Cth), which still largely reflects the recommendations of the Corporate Law Economic Reform Program Paper No 6, does not limit retail clients' access to complex products, and relies on a combination of product disclosure and, where personal advice is given, suitability and now "best interest" requirements. That approach reflects a policy view that properly informed clients can make rational choices as to the nature of the products they require and as to pricing.[1] However, regulatory confidence in disclosure was challenged prior to and in the global financial crisis, by wider developments in behavioural finance[2]; by the evident failures of decision-making, including by wholesale investors, in the period leading up to the global financial crisis; and, in Australia, by the significant losses to investors in Westpoint and Storm Financial. ASIC and IOSCO had also identified issues as to the effectiveness of disclosure in respect of the distribution of complex products.[3]

These issues were recognised in the Final Report of the Financial Services Inquiry (December 2014).[4] The FSI Report observed that reliance on disclosure, financial advice and financial literacy to protect consumers had not been adequate by reason of failures in advice and the inability of disclosure to address the problem, reflecting limits to consumers' ability to deal with complexity. The FSI Report recommended the introduction of a "targeted and principles-based product design and distribution obligation", which was to be imposed on product issuers and distributors in relation to the design and distribution of all products other than credit products, and would require identification of the type of consumer for which the product would be suitable

[1] P Hanrahan, *Legal Framework for the Provision of Financial Advice and Sale of Financial Products to Australian Households*, Royal Commission Background Paper 7, p 11.
[2] DC Langevoort, "Taming the Animal Spirits of the Stock Markets: A Behavioural Approach to Securities Regulation" (2002) 97 *NWUL Rev* 135; LA Stout "The Mechanisms of Market Inefficiency: An Introduction to the New Finance" (2003) *J Corp Law* 635; Financial Conduct Authority (UK) Occasional Paper No 1, *Applying behavioural economics at the Financial Conduct Authority* (April 2013); ASIC Report 427, *Investing in hybrid securities: Explanations based on behavioural economics* (March 2015); RJ Shiller, *Irrational Exuberance*, 3rd ed, 2015.
[3] IOSCO, *Final Report on the Regulation of Retail Structured Products* (December 2013); ASIC Report 384, *Regulating Complex Products* (January 2014); ASIC Report 400, *Response to Feedback on Rep 384 Regulating Complex Products* (July 2014).
[4] For commentary, see M Peckham, "From the Wallis report to the Murray report: a critical analysis of the financial services regime between two financial system inquiries" (2015) 33 *C&SLJ* 478.

and appropriate means of distribution. The Government accepted the FSI's recommendation to introduce design and distribution obligation in October 2015 and an initial Proposals Paper was released in December 2016.

These issues are also now recognised in the revised Exposure Draft Explanatory Memorandum (July 2018) to the Treasury Laws Amendment (Design and Distribution Obligations and Product Intervention Powers) Bill 2018 ("Proposed Bill") which notes that:

> "The Corporations Act relies heavily on disclosure to assist consumers in their understanding and selection of appropriate financial products. However, disclosure can be ineffective for a number of reasons, including consumer disengagement, complexity of documents and products, behavioural biases, misaligned interests and low financial literacy. The availability of financial advice may not be sufficient to overcome these issues. A consumer may not seek financial advice or may receive poor quality advice."

We should pause here to recognise some fundamental issues, which arguably marginalise some of the more detailed debate as to the desirability and content of the design and distribution and product intervention powers. With all the usual risks of rhetorical questions, is it, or should it be, common ground that:

1 Limitations in investor decision-making raise the risk or likelihood that the design or means of distribution of investment products will take advantage of:

- information disadvantages of retail investors, which could notionally be addressed by disclosure;
- behavioural biases, which could not readily be addressed by disclosure;
- other deficiencies in distribution mechanisms, for example, inappropriate recommendations by advisers induced by differing returns from particular products to the manufacturer, distributor or the adviser?[5]

2 These issues are exacerbated because many Australian investors do not seek advice from financial advisers, partly because of a historical perception that advice is or should be provided for free (or, more

[5] J Armour et al, *Principles of Financial Regulation*, 2016, 206, 212. As to the regulation of the retail market, see generally D Kingsford Smith, "Regulating Investment Risk: Individuals in the Global Financial Crisis (2009) 32 *UNSWLJ* 514; D Kingsford Smith, "ASIC regulation for the investor as consumer" (2011) 29 *C&SLJ* 327; N Moloney, "The Investor Model Underlying the EU's Investor Protection Regime: Consumers or Investors? (2012) 13(2) *European Business Organisation Law Review*, 169–193; D Kingsford Smith and O Dixon, "The consumer interest and the financial markets" in N Moloney et al (eds), *The Oxford Handbook of Financial Regulation*, 2015, 695–735; N Moloney, "Regulating the Retail Markets" in Moloney et al, above, 736-768.

accurately, be funded from charges included in the price of the product)?[6]

3 Even if advice is obtained, and despite the Future of Financial Advice Reforms, conflicts may still adversely affect the advice that is provided?

Unless one can comfortably answer all of these questions "no", then there is a strong case for design and distribution obligations or product intervention powers or both. Both can protect retail investors where suitability and "best interest" requirements do not apply, because products are distributed directly to consumers without the intervention of personal financial advice. Both can also provide means to address areas where financial incentives distort recommendations by advisers or investors do not take or do not understand advice before investing.

Australia is by no means alone in introducing design and distribution obligations. The product design and distribution obligations broadly correspond to the "financial product governance" requirements which have been introduced in the United Kingdom and the European Economic Union. In the United Kingdom, the Financial Conduct Authority ("FCA") has issued a Guidance Note dealing with the responsibilities of product issuers and distributors for the fair treatment of customers, which requires issuers to identify the target market for which a product is suitable; monitor the distribution of the product to ensure that is consistent with the target market; and periodically review products to determine whether they continue to meet the general needs of the target market. Product governance requirements in the European Union under MiFID II similarly require a "product manufacturers" to undertake a product approval process, identifying the target market of end clients, the relevant risks to that target market, and ensuring that the distribution strategy is consistent with the identified target market; and also require a product manufacturer regularly to review the instruments it offers or markets, taking into account any event that could materially affect the risk to the target market; and require product distributors, inter alia, to determine the "identified target market" for distribution on the basis of the "potential target market" determined by the manufacturer.[7]

Content of the design and distribution obligations

Proposed Part 7.8A of the *Corporations Act* would set out design and distribution requirements relating to financial products for retail clients. In its submissions to the Royal Commission, Treasury describes the purpose of the design and distribution obligation as "to promote the provision of suitable financial products to consumers of those products".[8] The Exposure Draft

[6] Treasury Submission to Royal Commission, *Key Reforms in the Regulation of Financial Advice*, p 1, citing Productivity Commission, Draft Report, *Competition in the Australian Financial System*, January 2018, p 355.
[7] For commentary, see B Geier and L Druckenbrodt, "Product Governance" (2015) 30(4) *Journal of International Banking Law and Regulation*, 241–245; G Pearson, "Suitability" (2017) 35 *C&SLJ* 464.
[8] Treasury, Submission to the Royal Commission, *Hearings on financial advice*, p 4.

Explanatory Memorandum (July 2018) similarly identifies the purpose of the design and distribution regime as to:

> "… assist consumers to obtain appropriate financial products by requiring issuers and distributors to have a customer-centric approach to marketing and distributing financial products." ([1.5])

The objects of Ch 7, as set out in s 760A, will also be amended to introduce an additional object, namely to promote "the provision of suitable financial products to consumers of financial products".

Before turning to the detail of these provisions, there are of course regular criticisms of the complexity of the drafting of the Corporations legislation.[9] One should recognise that complexity often reflects complex policy objectives, and the need to set boundaries as to what is in it and what is outside the regime, and that process is not necessarily a simple one. Even recognising that, the proposed design and distribution provisions are very complex by any standard. That complexity partly reflects the use of several complex defined terms, which in turn adopt definitions used elsewhere in Ch 6D and Ch 7, but often vary them so that they operate in a wider or narrower way than in those Chapters. They are also replete with criminal penalty consequences and offences arising from non-compliance.

Target market determinations

The first product design obligation requires an issuer to make a "target market determination" for its product. A target market determination must be made for products within the proposed regime as specified in proposed s 994B(1). That requirement applies to offers of financial products that require disclosure to investors under Pt 6D.2 or Pt 7.9 and to foreign offers recognised under Ch 8 and to products and in circumstances prescribed by regulation (proposed s 994B(1)). The July 2018 Exposure Draft also proposes to introduce s 764A(3) and s 765A(3)-(4) into the *Corporations Act* which permit the inclusion or exclusion of products within the definition of "financial products" for the purposes of Ch 7 and the design and distribution obligations. Treasury's Information Note suggests that this provision will allow the Government to act if a financial product is not currently regulated under the *Corporations Act* but is causing, will cause, or is likely to cause significant consumer detriment. It also has the potential to extend the operation of other parts of Ch 7, depending on how it is utilised.

Proposed s 994B(2) specifies the time at which a target market determination must be made. The regime would not apply to MySuper products, margin lending facilities, securities under an employee share scheme and ordinary shares in a company or foreign company (proposed s 994B(3)). The Exposure Draft Explanatory Memorandum (July 2018) notes that MySuper products are subject to special rules under the *Superannuation Industry (Supervision) Act* 1993 (Cth) and margin lending facilities are subject to Pt 7.8

[9] For example, *Ampolex Ltd v Perpetual Trustee Company (Canberra) Ltd* (1996) 20 ACSR 649, *Wingecarribee Shire Council v Lehman Bros Australia Ltd (in liq)* (2012) 301 ALR 1; [2012] FCA 1028.

Div 4A of the *Corporations Act*, and that fully paid ordinary shares are excluded from the regime as they are “fundamental to corporate fundraising" ([1.27]). The exclusion of fully paid ordinary shares in turn requires anti–avoidance provisions set out in proposed s 994B.

The requirement for a target market determination extends to both simple and complex financial products made available to retail clients. The Government’s December 2016 Proposals Paper recognised the policy choice involved in that approach and offered the somewhat unilluminating observation that:

> “covering all financial products under the design and distribution obligation, combined with a broad exception power to exclude specified products from the scope of the obligations, would help ensure broad coverage while at the same time providing flexibility to exempt certain products."

A more convincing rationale for extending the design and distribution obligations to simple products is that relatively simple products can be sold to persons who will not benefit from acquiring them, as the United Kingdom and local examples of product mis-selling indicate.

Proposed s 994B(5) requires that the target market determination for a financial product is in writing; describes the class of retail clients that comprises the target market for the product; and specifies any conditions and restrictions on retail product distribution conduct (as defined)[10] in relation to the product (defined as “distribution conditions”), other than a condition or restriction imposed by or under another provision of the *Corporations Act.* A note to proposed s 994B(5)(c) gives an example of a distribution condition, namely a restriction limiting distribution of the product to specified methods of distribution. The provision for a target market determination to include such conditions sensibly recognises that the risks of inappropriate distribution of products could be limited by particular steps being taken, for example to qualify clients by reference to their experience with the particular product, or to require that personal advice be obtained before investment is made in that product.

The target market determination must also specify the events and circumstances (defined as “review triggers”) that would reasonably suggest that the determination is no longer appropriate. The Exposure Draft Explanatory Memorandum (July 2018) ([1.57]) notes that the intent of the requirement for “review triggers” is that the maker of a target market

[10] The term “retail product distribution conduct” is defined in s 994A(1) as dealing in a product in relation to a retail client, giving a disclosure document in relation to an offer of the product to a retail client under Pt 6D.2 or 7.9, providing financial product advice in relation to the product to a retail client, or making a recognised offer in relation to a recognised jurisdiction of the product. The definition of the term “dealing” in s 994A(1) includes applying for or acquiring a financial product, issuing a financial product, or underwriting securities or interests, but not varying or disposing of a financial product, and includes regulated sales (as defined) of the product on a person’s own behalf. Treasury’s Information Note indicates that the definition of “retail product distribution conduct” is intended to extend to providing disclosure documents, providing general advice and dealing and not to include secondary sales of financial products or other variations to or cancellations of financial products and only to include activity in respect of retail clients.

determination should review and re-make that determination when events or circumstances suggest that it may no longer be appropriate, and suggests that what will constitute a “review trigger” will vary with the nature of the product and the circumstances in which it is issued, including the way in which it is distributed. It also gives examples of possible review triggers, such as an event or circumstance that would materially change a factor taken into account in making the target market determination for a product; whether the product is being distributed and purchased as envisaged by that determination; and the nature and extent of any feedback received from those who distribute or acquire the product. The target market determination must also specify “review periods” for a target market determination, which are the maximum period of time between the making of that determination and its first review, and between completed reviews of a determination, which must be reasonable in the circumstances to ensure that determination does not become inappropriate over time.[11] The requirement for review by reference to matters that may call the appropriateness of the target market determination into question, and at regular intervals, should in principle preserve the appropriateness of such determination. However, there may be a significant practical challenge for issuers in determining the scope of such a review and avoiding it taking on a formalistic character over time.

Proposed s 994B(8), as amended by the July 2018 Exposure Draft, would provide that:

> “A target market determination for a financial product must be such that it would be reasonable to conclude that, if an issue, or a regulated sale[12], of the product were to occur:
>
> (a) in accordance with the distribution conditions to a retail client—it would be likely that the retail client is in the target market; and
>
> (b) to a retail client in the target market—it would likely be consistent with the likely objectives, financial situation and needs of the retail client.”

This section is an important step in securing the integrity of a target market determination, requiring that the “distribution conditions” specified by the issuer be such that the product should (or, more precisely, “would be likely to”) reach its target market and not other investors and imposing, in effect, a suitability requirement for the target market. In order to determine whether it would be “reasonable to conclude” that the issue or regulated sale would meet that standard in a particular case, it may be necessary to determine what steps could notionally have brought about a result that it would be “likely” that the client was in the target market and the issue or regulated sale would “likely be consistent” with the client’s objectives etc. The ordinary meaning of the word ‘likely’ requires at least a real and not remote chance of that result,

[11] Exposure Draft Explanatory Memorandum (July 2018) [1.58].

[12] The term “regulated sale” is defined as a sale that needs disclosure to investors under Pt 6D.2, by the application of s 707(2), (3) or (5) or in relation to which a product disclosure statement must be given under s 1012C(5), (6) or (8).

whether or not that chance is greater or less than 50%.[13] The section may be satisfied although that did not in fact occur.

This section has been amended since the earlier Exposure Draft, and Treasury's Information Note indicates that its present form is intended to address concerns that the previous provision required a financial product to meet 'all' of the objectives, financial situation and needs of the target market and issuers to know individual customers. The Exposure Draft Explanatory Memorandum (July 2018) ([1.53]) also recognises that the matters specified in s 994B(8)(b) are similar to those used in respect of the suitability of personal advice, but suggests that this does not reflect any requirement to take into account personal circumstances of any particular person or provide personal advice. The definition of "personal advice" in s 766B(3) will be amended expressly to exclude requests for information solely to determine whether a person is in a target market for a financial product, and informing the person of the result of that determination, although there is room for debate as to the scope of that exclusion.

There is no doubt also a degree of complexity in an issuer determining whether a product is suitable for distribution to a particular market segment, where that involves questions as to the levels of risk and choice that are suitable for that market. However, there seems to be no reason in principle why an adequate product would not be likely to satisfy the objectives etc of a particular group, even if they have individual differences. It should at least be evident, in determining a target market, if the product would *not* meet significant needs of that market, for example because it did not deliver sufficient liquidity for the needs of that market, or because it exposed the relevant class of investors to too great a risk of loss.

The July 2018 Exposure Draft also adds proposed s 994B(9) to require issuers to make target market determinations available to the public free of charge, although it may be an open question who (other than possibly trade competitors, the financial media and ASIC) will seek to take advantage of that access. Advertising and promotional material for a financial product that requires a product disclosure statement will also need to refer to a product's target market: s 1018A (as amended).

Review of target market determinations

The second design obligation requires an issuer to review a target market determination for a financial product during a review period (as defined) and when a review trigger (as defined) occurs, or an event or circumstance occurs that would reasonably suggest that the target market determination is no

[13] Compare *Boughey v R* (1986) 161 CLR 10; 60 ALJR 422 at 426; [1986] HCA 29; *James Hardie Industries NV v Australian Securities and Investments Commission* (2010) 274 ALR 85; 81 ACSR 1; [2010] NSWCA 332. By contrast, in *Australian Securities Commission v Nomura International plc* (1998) 89 FCR 301; 29 ACSR 473 at 561, Sackville J held that the 'likely to create' limb of former s 998 of the Corporations Act required that there was more than a 50% chance that the relevant trading would create a false or misleading appearance with respect to the price of the securities, and that it was not sufficient to establish that limb that there was a real and not remote chance that such trading might do so.

longer appropriate. Proposed s 994C deals with that review and sets out a complex regime dealing with the position where that review is not undertaken or a target market determination is or may no longer be appropriate. The July 2018 Exposure Draft proposes to amend these sections to provide that, upon a review being triggered, distribution must stop as soon as practicable or within 10 business days, rather than "immediately" as the previous draft required. It is sensible, in principle, that distribution should be suspended in these circumstances, until a new target market determination is made.

Under s 994C(3)-(4), the maker of a target market determination commits a criminal offence or is exposed to a civil penalty if it engages in retail product distribution conduct where it knows that a "review trigger for a determination has occurred or "an event or circumstance has occurred that would reasonably suggest that the target market determination is no longer appropriate". The criminal offence requires actual knowledge of these matters, and the civil penalty also applies where the maker of that determination ought reasonably to have known those matters. Is the alternative test, referring to an event or circumstance that would "reasonably suggest" that the target market is no longer appropriate, more, or less, demanding than the "reasonably suspect" standard used elsewhere in the *Corporations Act?* Will it be triggered at the first point that an issuer has notice of such an event or circumstance, but has not yet investigated the position?

Proposed s 994C(5) in turn requires a person who made a target market determination to take all reasonable steps to ensure that persons who engage (or are expected to engage) in retail product distribution conduct in relation to the product are informed that they must not do so until the new target market determination has been made (other than in respect of excluded conduct, as defined).

Prohibition on engaging in retail product distribution conduct unless target market determination made

The first distribution obligation, attaching to persons who engage with a potential investor in relation to a product, prohibits retail product distribution conduct (as defined) in relation to a financial product if the issuer has failed to make a target market determination in respect of the product. Broadly, proposed s 994D prohibits a regulated person (as defined) from engaging in retail product distribution conduct (as defined) in relation to a product unless the regulated person made all inquiries (if any) that were reasonable in the circumstances and, after doing so, believed on reasonable grounds that a target market determination had been made; or the Part did not require a target market determination for the product; or the distribution conduct was excluded conduct (as defined)[14].

[14] The concept of "excluded conduct" is defined in s 994A as an "excluded dealing" and providing personal advice, and the term "excluded dealing" is defined as a person, or their associate, arranging for a retail client to apply for or acquire the product, for the purpose of implementing personal advice that the person has given to the retail client.

The July 2018 Exposure Draft amends the proposed section so that, where a distributor reasonably concludes that a target market determination is not required for a product, it will not contravene the prohibition against distributing financial products without a target market determination. A distributor would at least need to assess whether a product is outside the regime to have a reasonable basis for concluding that a target market determination is not required. It may be unlikely that such a reasonable basis would be established by, for example, simply relying on a representation by the issuer to that effect.

Further distribution obligations

Proposed Div 3 imposes further obligations as to the distribution of relevant financial products. Broadly, distributors would be required to put in place reasonable controls to ensure products are distributed in accordance with the identified target markets and comply with reasonable requests for information from the issuer in relation to the review of the products.

Proposed s 994E, which is again very complex in its drafting, broadly requires a person who makes a target market determination for a financial product to take reasonable steps that will, or are reasonably likely to, result in retail product distribution conduct (as defined) in relation to the product (other than excluded conduct) being consistent with the target market determination (proposed s 994E(1)-(4). Proposed s 994E(2) provides that:

> A person is not taken to have failed to take reasonable steps for the purpose of [s 994E(1)] merely because:
>
> (a) retail product distribution conduct of a regulated person (other than the person) in relation to the product is inconsistent with the target market determination; or
>
> (b) a retail client who is not in the target market for the product acquires the product.

Although this section excludes a finding of that failure “merely because” of those matters, it should not prevent these matters being taken into account in determining whether “reasonable steps” were taken, where these matters may otherwise suggest that such steps were not taken.

Proposed s 998E(5) specifies, in a non-exclusive way, matters that are relevant to whether such steps are reasonable steps. The Exposure Draft Explanatory Memorandum (July 2018) ([1.88]-[1.89]) indicates that the reference to “reasonable steps" is intended to adopt a risk management approach, and ensure that the obligation is “scalable” (in that now fashionable term) according to the risk associated with inappropriate distribution of a product and the practicality of mitigating the risk. This provision seems to be drafted so that the taking of “reasonable steps" is a component of the obligation, rather than a defence, which will require a regulator to establish a failure to take those “reasonable steps" in order to establish a breach of the obligation. The view that issuers, their advisers and the courts take as to the content of this obligation will likely have a significant effect upon compliance costs and upon the prospects of success of an action for failure to comply with the obligation.

Record keeping

Proposed s 994F(1) relates to record keeping in respect of a product issuer's target market determination, review triggers, review periods and the reasons for decisions about them. These provisions are amended in the most recent draft and contemplate that issuers will specify the information that must be kept, who must keep it and, if kept by a third party distributor, how often that information must be provided to the issuer. The issuer would be required to request sufficient information at sufficient frequency so that it can promptly determine if a review of a target market determination should be undertaken and record reasons for this decision. Treasury's Information Note indicates the record keeping requirement "is intended to be scalable and flexible according to the financial product."

Proposed s 994F(2) requires a regulated person[15] who engages in retail product distribution conduct (as defined) to collect and keep records of specified information in relation to the relevant product, including the number of complaints in relation to the product that the regulated person receives and the steps the regulated person has taken in relation to the product as required by s 994E (reasonable steps to ensure consistency with the target market determination).

A regulated person (as defined) must notify the product issuer of specified information, including as to the number of complaints concerning a product, to persons who make target market determinations. That provides a sensible trigger for reviews of target market determinations, so far as a multitude of complaints may well indicate an issue with a product. The absence of complaints is of course a much weaker indicator, since difficulties with a product may only emerge over time or in particular market conditions. A regulated person must also notify the product issuer of significant dealings in the product than are not consistent with the target market determination (proposed s 994F(5)). The term "significant" is again not defined and the Exposure Draft Explanatory Memorandum (July 2018) indicates it is intended to take its ordinary meaning, but adopts an issuer's perspective in determining that question, referring to whether the matter would be worthy of the issuer's attention ([1.101]).

Notifications to ASIC

The proposed legislation imposes requirements as to notification to ASIC of significant dealings in a product that are not consistent with its target market determination. Proposed s 994G requires a person who (1) makes a target

[15] The term "regulated person" is defined in proposed s 994A, for the purposes of Pt 7.8A, as a "regulated person" as defined in s 1011B, as further varied, which includes issuers of financial products and securities, a seller of a financial product or securities in specified circumstances, a financial services licensee or authorised representative of that licensee, and other persons; a seller of financial products, within some of the circumstances specified in s 707 and 1012C; an offeror of the financial product within the meaning of Ch 8; or a person prescribed by regulation.

market determination for a financial product, (2) becomes aware of a significant dealing in the product in relation to a retail client (except an excluded dealing, as defined) and (3) becomes aware that the dealing is not consistent with the target market determination, to give written notice to ASIC as soon as practicable and in any case within 10 business days.

The notice requirement under this section appears to be limited to where the relevant person has actual knowledge that the dealing is not consistent with the determination, which may be more difficult to establish than, for example, reason to suspect that matter. The Exposure Draft Explanatory Memorandum (July 2018) also notes that "significant" is not defined, that its content is intended to take its ordinary meaning in the context of the new provisions and that this would generally require an issuer to inform ASIC of dealings that would be worthy of ASIC's attention having regard to the object of the new regime and ASIC's role as regulator.[16] It seems to me this test would be more likely read as an objective test or by reference to investor interests.

ASIC's powers in respect of product distribution obligations and civil liability

Proposed s 994H allows ASIC to require (1) a person who makes or is required by to make, a target market determination; or (2) a regulated person (as defined) who engages in retail product distribution conduct (as defined) in relation to a financial product to provide ASIC with specified information, including distribution information, relating to the financial product. Proposed s 994J allows ASIC to make a stop order if it is satisfied that a provision of Pt 7.8A Div 2 (target market determinations) or s 994E (reasonable steps to ensure consistency with the target market determination) has been contravened in relation to a financial product, generally subject to a requirement for a hearing, and also allows the making of an interim order without a hearing in circumstances of urgency.

Proposed s 994M provides for civil liability where a person contravenes specified sections and another person (defined as the "client") suffers loss or damage because of the contravention. In that case, the client (as defined) may recover the amount of the loss or damage by action against the relevant person. The July 2018 Exposure Draft extends this section to permit consumers to commence a civil action for losses resulting from an issuer's failure to notify, or a distributor failing to stop distributing when notification has occurred, in the event of a review being triggered. Proposed s 994N allows the court to make additional orders in dealing with an action under s 994M(1), in addition to awarding loss or damage under that subsection. Although there would be the usual cost disincentives to individual actions for breach of these obligations, there is real scope for representative or class actions in that regard.

[16] Exposure Draft Explanatory Memorandum (July 2018) [1.74].

Transitional provisions

The July 2018 Exposure Draft proposes to amend the application and transitional provisions so that these obligations will apply to all financial products two years, rather than one year, after the legislation receives royal assent.

Some wider comments

The case for design and distribution obligations will likely be strengthened by the issues that are now emerging in evidence at the Royal Commission into Misconduct in the Banking Superannuation and Financial Services Industry. The recognition of issues as to the effectiveness of regulation of financial advice in the Royal Commission may also support a case for extending design and distribution obligations (and product intervention powers) to circumstances where personal advice is given, although these amendments largely do not do so. It is doubtful that the design and distribution obligations will address wider issues, including the distribution of financial products with minor economic differences which make it more difficult for consumers to compare features and prices.[17]

Product intervention powers

The FSI Final Report also recommended the introduction of a product intervention power which ASIC could exercise where there is a "risk of significant consumer detriment" to a class of consumers, even if there was no existing or suspected breach of the law, although it also suggested that power should not be used to address problems with pricing or for pre-approval of products (recommendation 22). The FSI Report proposed that power would permit ASIC to require amendment to marketing or disclosure materials, warnings to consumers, restrictions on distribution or the banning of financial products, up to a maximum of 12 months, and be subject to judicial review.

Again, the proposed power is not unique to Australia. The *Financial Services Act* 2012 (UK) authorises the FCA to make rules for product intervention which may prohibit conduct by authorised persons as appears necessary for advancing the FCA's consumer or competition objectives; see also Financial Services Authority, Discussion Paper 11/1, "Product intervention" (January 2011); Policy Statement 13/3, "The FCA's use of temporary product intervention rules" (March 2013). The FCA invoked the product intervention power to limit the distribution of contingent convertible bonds to retail investors in 2014. The European Securities Markets Authority is also authorised by MiFID to temporarily prevent or restrict the distribution of or sale of certain types of financial product instruments or a type of financial activity or practice, where there is a, inter alia, a significant consumer protection concern. The Securities and Futures Commission in Hong Kong has power to prohibit the advertising and public offering of structured products, which is

[17] Productivity Commission, *Competition in the Australian Financial System – Draft Report*, January 2018; P Hanrahan, *Legal Framework for the Provision of Financial Advice and Sale of Financial Products to Australian Households*, above p 85.

narrower than the proposed Australian product intervention power.

Proposed Pt 7.9A of the *Corporations Act* deals with product intervention orders. Proposed s 1023A specifies the object of the Part as follows:

> "The object of this Part is to provide ASIC with powers that it can use proactively to reduce the risk of significant detriment to retail clients resulting from financial products."

The product intervention power will apply to financial products regulated by the *Corporations Act* that are, or are likely to be, available for acquisition by retail clients by way of issue (proposed s 1023D) and will also extend to products that may be provided by a person in the course of engaging in a credit activity or proposed credit activity for the purposes of the *National Consumer Credit Protection Act* 2009 (Cth) ("*Credit Act*"), including credit contracts, mortgages and guarantees and consumer leases. Anti-avoidance provisions extend the application of the section to secondary sales situations specified in ss 707 and 1012C of the *Act*: proposed ss 1023B, 1023D(1)(a), 1023D(3)(a).

Treasury's Information Note indicates that the Government is also considering using the regulation-making power in respect of the definition of financial products (to which I referred above) to allow ASIC to use the product intervention power with respect to funeral expenses insurance, extended warranties that are functionally equivalent to add-on insurance and short term credit that is not regulated under the *Credit Act*. These products are arguably the subject of regulatory concerns for good reason. However, the extension of this regime to them may still highlight its controversial aspects. Are there some product categories in which it is not possible to design a product that will comply with these obligations? Will obligations of this kind exclude some products from the market? If that exclusion reflects an inability to design a compliant product, is there any reason to regret that exclusion?

What can be done by way of intervention

Broadly, the proposed product intervention power will allow ASIC to intervene in relation to a product (or class of products) where ASIC is satisfied that the product (or class of products) has resulted in, or is likely to result in, significant consumer detriment to retail clients (proposed s 1023D(1)). Proposed s 1023D(3) confers a corresponding power in respect of a class of financial products. The power to make that order turns on ASIC's state of satisfaction as to that matter, which is related to but not the same as the underlying fact that a product has those risks.

ASIC may then order that a specified person must not engage in specified conduct in relation to the product or class of products, either entirely or except in accordance with conditions specified in the order. A note to the section gives an example of conditions that may be specified in a product intervention order, namely that the product or class of products not be issued to a retail client unless the retail client has received personal advice. Other actions which ASIC could take include requiring amendment of product marketing and disclosure materials; imposing new consumer warnings and labelling changes; restricting how a product is distributed; and banning products.

Certain matters that may not be specified in such an order, namely a condition that a person satisfy a standard of training, or meet a professional standard, other than a standard otherwise prescribed for the person by or under the *Corporations Act*; a condition that a person who is not required to hold an Australian financial services licence become a member of an external dispute resolution scheme; or a condition related to a person's remuneration, *other than* a condition related to so much of the person's remuneration as is conditional on the achievement of objectives directly related to the financial product (proposed s 1023D(4)). Proposed s 1023D(5) makes clear that conduct covered by a product intervention order must be limited to conduct in relation to a retail client.

Proposed s 1023E(1) specifies several matters that ASIC must take into account in considering whether a financial product has resulted in, or will or is likely to result in, significant detriment to retail clients, namely (1) the nature and extent of the detriment; (2) the actual or potential financial loss to retail clients resulting from the product; (3) the impact that the detriment has had, or will or is likely to have, on retail clients; and (4) any other matter prescribed by regulations made for the purposes of this paragraph. The Exposure Draft Explanatory Memorandum (July 2018) ([2.31]) explains the concept of "significant", in the context of the product intervention power, as taking its ordinary meaning, but suggests that:

> "generally, this would require the detriment to be sufficiently great to justify an intervention, having regard to the circumstances of the case and the object of the intervention power."

That subsection expressly does not limit the matters to be taken into account in determining that matter (proposed s 1023E(2)). Proposed s 1023E(3) makes clear that disclosure is not a complete protection against the making of such an order, stating that:

> "A financial product may result in significant detriment to retail clients even if a person has complied with the disclosure requirements in Chapter 6D or this Chapter, and with the person's obligations under Part 7.8A, in relation to the product."

This provision should not be a matter for concern unless one retains unqualified confidence in disclosure. Proposed s 1023F specifies requirements as to consultation before ASIC makes a product intervention order.

A product intervention order may remain in force for 18 months, or any shorter period specified by the regulations; or any shorter period specified in the order (proposed s 1023G(2)). That section recognises the possibility that the Court may make an order staying or otherwise affecting the operation or enforcement of a product intervention order, although Pt 7.9A does not itself provide for such an order. Presumably, such an order could be sought under the *Administrative Decisions (Judicial Review) Act* 1977 (Cth) or under s 39B of the *Judiciary Act* 1903 (Cth). Proposed s 1023H allows ASIC to extend a product intervention order indefinitely or for a specified period, by legislative instrument, with ministerial approval.

A product intervention order in relation to a financial product may require a specified person to take reasonable steps to notify the retail client of the terms of the order and of other matters, and may also specify the ways in which, and the periods within which, that notification is given (proposed s 1023N). The limitation to "reasonable steps" was introduced by the July 2018 Exposure Draft. Engaging in conduct contrary to a product intervention order that is in force in relation to the person is an offence and a contravention of a civil penalty provision (proposed s 1023P). A retail client may recover loss that it has suffered because of a contravention of such an order against a person who contravened that order (proposed s 1023Q) and the Court may also make additional orders in such an action (proposed s 1023R).

Treasury seems to take a relatively wide view of the potential use of design and distribution obligations and product intervention powers (without distinguishing the two) in its submissions to the Royal Commission, suggesting that these provisions could be used to ban remuneration practices where there is a link between remuneration and distribution of the product.[18] An ASIC Commissioner has also expressed the view that the product intervention power would permit ASIC to make a prohibitive order in respect of remuneration linked to a product, where significant consumer detriment is caused by misaligned incentives constituted by remuneration structures.[19] In its submission to the Royal Commission in respect of consumer finance, ASIC also identified the possible use of the product intervention power to prohibit remuneration structures that create unacceptable risks to consumers, and noted that this could be used to address "first mover" difficulties with a single market participant moving away from existing remuneration structures. Of course, these matters might previously have been addressed by the Future of Financial Advice reforms, but for the range of exceptions that reduced their practical effect.

Practical issues with the exercise of the product intervention power

There may still be real practical difficulties for ASIC in exercising a product intervention power; a real risk that the exercise of that power will have adverse effects on clients who have existing investments in products; and a real risk that ASIC will be criticised, with hindsight, both when it exercises that power and when it is asked to and does not exercise that power.

Consider the example of Storm Financial, which is often given in support of the need for this power. If ASIC then had a product intervention power, should it have exercised it to prohibit the issue of the financial products by third parties to clients of Storm Financial when the first indicators of the global financial crisis arose? Had it done so and the global financial crisis passed without real effect, existing and potential investors may well have suffered real

---

[18] Treasury, Submission to the Royal Commission, *Hearings on financial advice*, p 5.
[19] P Kell, "A Better Toolkit for ASIC", speech given at Thomson Reuters Regulatory Summit 2017, 6 June 2017, p 6.

losses from the intervention. Had ASIC not done so, because the risk of further deterioration in the markets was then uncertain, it would equally have been exposed to criticism when investors subsequently suffered loss.

Another example used to justify a product intervention powers is the failure of the several agribusiness managed investment schemes. Could the risks of the leverage in the business models of those schemes, brought home by the global financial crisis, have been identified by ASIC prior to the event with sufficient confidence to exercise a product intervention power? Would ASIC's perception that a business model is too heavily leveraged warrant the exercise of such a power? How does one weight the risk of harm to existing investors when the power is exercised against the risk of harm to future investors if it is not? Does the protection of future investors always, or only sometimes, justify product intervention notwithstanding its risks for existing investors in a product?

I make these comments not merely to advance the unsurprising proposition that a regulator's lot is not a happy one. There is a potentially more significant difficulty where the benefit or harm of the exercise of a regulatory power is contingent on future events, and criticisms of its exercise (or the failure to exercise it) may undermine public confidence in the regulator over time.