



Association of Financial Advisers Ltd
ACN: 008 619 921
ABN: 29 008 921
PO Box Q279
Queen Victoria Building NSW 1230
T 02 9267 4003 F 02 9267 5003
Member Freecall: 1800 656 009
www.afa.asn.au

Financial Services Unit
Financial System Division
The Treasury
Langton Crescent
PARKES ACT 2600

By email: ProductRegulation@treasury.gov.au

20 March 2017

Dear Product Regulation Team,

AFA Submission – Design and Distribution Obligations and Product Intervention Power

The Association of Financial Advisers Limited (AFA) has served the financial advice industry for 70 years. Our objective is to achieve *Great Advice for More Australians* and we do this through:

- advocating for appropriate policy settings for financial advice
- enforcing a Code of Ethical Conduct
- investing in consumer-based research
- developing professional development pathways for financial advisers
- connecting key stakeholders within the financial advice community
- educating consumers around the importance of financial advice

The Board of the AFA is elected by the Membership and all Directors are required to be practising financial advisers. This ensures that the policy positions taken by the AFA are framed with practical, workable outcomes in mind, but are also aligned to achieving our vision of having the quality of relationships shared between advisers and their clients understood and valued throughout society. This will play a vital role in helping Australians reach their potential through building, managing and protecting wealth.

The AFA’s position

The AFA supports each of Treasury’s proposals to establish financial product design and distribution obligations and augment ASIC’s ability to regulate the distribution of credit and financial products. The AFA agrees that the power to intervene in distribution should be predicated on preventing significant consumer detriment and the principles underlying the financial product design and distribution obligations are reasonable and practical. This is a welcome reform that the AFA has been seeking for some time.

The AFA has responded to some selected questions that Treasury has sought input on and further below recommended that the proposed measures be rolled out after a review of the retail client / wholesale client thresholds.

Responses to Treasury questions

Credit products subject to the proposed measures

The AFA supports credit products being subject to the product intervention power but not the design and distribution obligations because the National Consumer Credit Protection Act and the associated Consumer Credit Code already provide a comprehensive regulatory framework for credit product design and distribution. The AFA would not support an overlapping system that complicated the responsible lending requirements implemented seven years ago or caused confusion amongst credit providers or mortgage brokers.

The proposed obligations for ‘issuers’ and ‘distributors’

The AFA agrees with the obligations Treasury has proposed for ‘issuers’ and ‘distributors’. The requirements to identify target and non-target markets, select distribution channels appropriate for the target markets, while ensuring consumer choice, and put in place reasonable controls to ensure products are distributed in accordance with the issuer’s expectations bring issuers and non-advising distributors closer to the standard of care required of financial advisers when recommending and arranging financial products for their clients. Accordingly, the AFA supports issuers being required to assess the risks associated with a distribution channel, steps to mitigate those risks and the complexity of the product when determining an appropriate target market. The AFA considers that this information will assist financial advisers to recommend appropriate financial products to consumers and will generally assist to mitigate against information asymmetry being a cause of financial losses.

This will be a welcome complementary measure to the package of Life Insurance Framework reforms announced by the Minister in November 2015. Requiring insurers to consider whether consumers in the target market would derive any benefit from the features of the product is an important aspect to ensuring that insurance contract terms are in consumers’ interests. The AFA considers this an important part of insurers meeting their duty of utmost good faith and this reform may help to drive innovation in life insurance products in future.

Further, the obligations to review the target markets periodically and post-sale place a similar level of ongoing responsibility and consideration by product issuers towards consumers as financial advisers already have. The AFA supports the issuer and distributor obligations being represented in a detailed manner in legislation and supported by guidance from ASIC to clarify the interpretation of the obligations.

If a consumer chooses to access a product despite being aware that they are outside the target market, the AFA expects that the general consumer protections under the ASIC Act 2001, and Australian Consumer Law should protect most of those types of consumers. However, the principle of informed decision making should prevail and distributors should be required to inform consumers who are outside a target market that they may not be protected by all the legal protections afforded to target market consumers. This is a similar requirement to the requirement for financial advisers to warn clients when they are provided with general advice as to what are the consequences of proceeding and consumers should be entitled to expect similar treatment from other distribution channels.

Product interventions

The AFA agrees with and supports Treasury's proposals to increase ASIC's powers to intervene and remediate breaches by product issuers and distributors beyond defective disclosure. This is a welcome improvement in consumer protections and applying scale to the enforcement powers is a practical initial approach to measures. Should the application of a potential scale of detriment to consumers be subsequently determined to be restrictive of coverage or effectiveness, this measure can be amended.

The AFA is concerned, however, that the procedural requirement for ASIC to engage in consultation with the individual or the market that is subject to possible intervention may reduce the effectiveness and timeliness of ASIC's powers of intervention. This approach must be balanced against the size / scale of possible consumer detriment to ensure that the consultation stage does not exacerbate consumer detriment. The AFA supports procedural fairness and the right for a subject to provide an explanation or response. However, this should not be at a cost to consumers and must be balanced with good risk management practices.

The AFA supports all the possible interventions listed in Section 4. By not limiting the range of interventions, the AFA considers that ASIC should be well equipped to be effective. The AFA agrees with the duration of interventions lasting 18 months. Should ASIC feel it necessary to impose an intervention after considering the scale of consumer detriment, engaging with the intervention subject and good risk management practices, an 18-month duration to an intervention should provide the product providers sufficient time to overcome and rectify any deficiencies identified by ASIC whilst providing ASIC with an appropriate timeframe to be effective in its enforcement activities – including time to respond and deal with any applications for review.

The AFA considers that ongoing non-compliance following an ASIC intervention should subject the product provider to the full range of sanctions, including but not limited to administrative

sanctions such as licensing action, injunctive actions to protect consumers and contain the damage, and in appropriate cases, civil and criminal penalties. Financial services providers are already subject to these sanctions in particular circumstances, and extending this range of sanctions to product providers, product issuers, product distributors and associated companies is a sensible and welcome measure.

AFA Recommendations

Issuer and distributor definitions

The AFA agrees that distributors who provide personal financial product advice to consumers of financial products should not be captured under the proposed distribution obligations because the obligations upon financial advisers are already very comprehensive since the implementation of FoFA. Further, as the FoFA reforms are still in their infancy, the AFA considers that the benefits of those reforms should be permitted time to show their benefit in improving consumer protections prior to further reforms being implemented. The AFA also agrees that implicit in the FoFA obligations to provide advice that is in the client's best interest and to provide advice about financial products that are appropriate for a client is an existing requirement – similar to that proposed – that financial advisers consider the target market of a financial product. This is similar to the requirement prior to FoFA that financial advisers demonstrate that they knew the product which goes hand in glove with the Know Your Client rule.

However, the AFA considers that the requirement for 'distributors' to receive a benefit from an issuer to be captured by the distributor obligation may limit the application of the obligations. In the AFA's experience, although most people who are involved in arranging for a person to acquire an interest in a financial product receive either a commission, a referral fee, a salary or some non-monetary benefit, there are a couple of examples where the distributor may not receive a benefit from the issuer. The issue is with the circumstances that some self-managed superannuation funds (SMSFs) are established.

Property spruikers hold 'investment seminars' that focus on providing information about financial products and real property. Whilst some seminars may be designed to provide attendees with general advice, others focus on information-only services. In those settings, careful scripting is used by the presenters to provide information about property investments through SMSFs. The seminars are designed to influence the attendees – often retirees or near-retirees – to establish self-managed superannuation funds.

Where a seminar can largely avoid any perception of general advice being provided, the operators are not required to hold an Australian Financial Services Licence. Some seminars have aligned accountants, lawyers or other professionals who they refer the attendees to in order to do the work involved with establishing a self-managed superannuation fund. The seminar presenters may not receive any benefits from those professionals (the SMSF-issuers) in relation to the consumers' decision to establish an SMSF other than the fees they receive from the seminar attendees.

The AFA considers that the requirement to receive a benefit from the product issuer in order to be considered a ‘distributor’ of a financial product may effectively carve out some property spruiking and SMSF investment models from the proposed measures. The measures are intended to capture both licensed and unlicensed issuers and distributors. Accordingly, the requirement to receive a benefit from a product issuer limits the operation of the proposed measures by effectively carving out some unlicensed activity that focuses on only providing information about financial products.

Likewise, when an accountant establishes an SMSF for a client without providing any financial product advice (known as ‘acting on the client’s instructions’), the accountant receives no benefit from other financial product issuers. Instead, they are paid by the client. Whilst the accountant has to be licensed to arrange for a client to acquire an interest in an SMSF (known as ‘dealing in’ SMSFs authorisation), they would not appear to meet neither the proposed ‘distributor’ or ‘issuer’ definitions.

This is because whilst the accountants in effect do issue the SMSF to the trustees of the SMSF – by creating a trust deed and administration framework for the trustees – once established the trustees carry the responsibilities under the SMSF, not the accountant. This payment may be made prior to the creation of the SMSF and therefore prior to the client subsequently being considered to be an issuer of the product. If the accountant does not subsequently provide advice on rolling over funds to the SMSF or acquiring other investments, they will be paid by the client for establishing the SMSF and not a particular financial product issuer.

Accordingly, non-advising but SMSF-dealing accountants would also appear to not meet the definition of a ‘distributor’ under the proposed measures. Unless our interpretation of the proposed definitions is incorrect, this would appear to present a gap in the proposed framework, despite the intention to capture unlicensed arranging of financial products.

An option to resolve this apparent gap would be to apply the Corporations Act of ‘dealing in’ under section 766C to the definition of issuer, just as it is proposed to incorporate the Corporations Act definition of issuer into the proposed measures. This would then apply the issuer obligations to such accountants and ensure that any associates whom they engage with to advertise their SMSF-establishment services could then become subject to the distributor obligations. However, as noted above, if the accountant does not pay the distributor / spruiker the current definition of a ‘distributor’ may not apply to those business models.

Limited to retail clients

There is one aspect to the proposals that the AFA does not agree with – limiting the design and distribution obligations and the product intervention power only to products made available to retail clients. In the AFA’s view, the current retail client thresholds under section 761G and its associated regulations have not kept pace with the rate of inflation or household wealth. These thresholds have not changed since they were established sixteen years ago and as a result, it is too easy at the moment for consumers to be carved out of the consumer protections framework. Older Australians, in particular, are too often the target of unscrupulous operators who give them the

means to establish a self-managed superannuation fund, thereby taking advantage of the current “legal uncertainty”¹ around when the consumer protection laws apply to SMSF trustees.

The proposals paper says that the measures are intended to be approached holistically. The AFA agrees with this approach and accordingly recommends that before the proposed measures are implemented, the wholesale client net assets test and product value / price test be reviewed to consider the quantum that they should be at had indexation been applied to the original thresholds when they were introduced sixteen years ago. Once the thresholds are at the correct levels to justify excluding wholesale clients from the proposed measures, the AFA would support the proposals being limited to retail clients.

If the thresholds cannot be reviewed before the proposed measures need to be implemented, the AFA would recommend the measures apply to both retail and wholesale clients until the wholesale client thresholds can be reviewed and modernised.

Concluding comments

The AFA supports Treasury’s proposals to introduce additional obligations upon financial product issuers and distributors. These measures will complement existing consumer protections, as well as structural reforms that are underway. For too long, regulation of financial products has focussed on disclosure obligations. Financial products can be very complex products and it is not appropriate to expect all non-advised consumers to be capable of understanding financial products.

Whilst the AFA considers that product disclosure documents need reviewing – especially to develop standardised summary sections in plain language that can improve a consumers’ understanding – the proposals to require issuers and distributors to have regard to target market considerations and put in place reasonable controls, are practical and equitable to other higher-regulated operators in the financial services sector. The AFA considers that the proposed measures will distribute responsibility for consumer protection throughout the sector and help to create cultures within product design and distribution teams that are better aligned to consumer interests than they are currently. In time, these measures should help the product design and non-advised distribution channels restore their social licence and support financial advisers with better information to help them act in their clients’ best interests.

It is important to us that where conduct has failed consumers, that all interested stakeholders including regulators, government, media and the public are able to clearly see where such a failure

¹ Media Release 14-191MR, *Statement on wholesale and retail investors and SMSFs*, Australian Securities and Investments Commission (issued 8 August 2014), available at <http://asic.gov.au/about-asic/media-centre/find-a-media-release/2014-releases/14-191mr-statement-on-wholesale-and-retail-investors-and-smsfs/>

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has emanated. These measures help separate product failure from advice failure, and to that end we believe the measures are generally in the public interest.

Aside from the two recommendations for the retail client thresholds to be reviewed before implementing these measures and to review the definitions of ‘issuer’ and ‘distributor’ to ensure comprehensive coverage, the AFA supports the proposed measures.

If you require clarification of anything in this submission, please contact us on 02 9267 4003.

Yours sincerely,

A handwritten signature in black ink, appearing to read 'B Fox', is positioned below the text 'Yours sincerely,'.

Brad Fox
Chief Executive Officer
Association of Financial Advisers Ltd