FINANCIAL SERVICES COUNCIL

Design and Distribution Obligations regulations

FSC submission

14 October 2019

FSC FINANCIAL SERVICES COUNCIL

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1 About the Financial Services Council

The FSC is a leading peak body which sets mandatory Standards and develops policy for more than 100 member companies in Australia's largest industry sector, financial services.

Our Full Members represent Australia's retail and wholesale funds management businesses, superannuation funds, life insurers, financial advisory networks and licensed trustee companies. Our Supporting Members represent the professional services firms such as ICT, consulting, accounting, legal, recruitment, actuarial and research houses.

The financial services industry is responsible for investing $3 trillion on behalf of more than 15.6 million Australians. The pool of funds under management is larger than Australia's GDP and the capitalisation of the Australian Securities Exchange and is the fourth largest pool of managed funds in the world.

2 FSC comments

The FSC welcomes the opportunity to provide comment on the draft Corporations Amendment (Design and Distribution Obligations) Regulations 2019 (**Draft Regulations**).

The FSC is supportive of the policy intent of the design and distribution obligations (**DDO**) regime. The FSC's comments on the Draft Regulations are focussed on ensuring:

- the DDO regime operates as intended;
- avoids uncertainty and unintended consequences for consumers; and
- promotes industry innovation, efficiency and competition.

All references to sections in this submission, unless otherwise specified, are references to sections of the *Corporations Act 2001* (Cth) (**Corporations Act**) as amended by the *Treasury Laws Amendment (Design and Distribution Obligations and Product Intervention Powers) Act 2019* (Cth).

2.1 Rights in relation to an IDPS

The Draft Regulations include a proposed regulation 7.8A.03 that specifies seven categories of financial product in relation to which a target market determination (**TMD**) must be made where the issue or sale of the product would not otherwise require a prospectus or product disclosure document to be prepared.

The fourth item in this table relating to Investor Directed Portfolio Services (**IDPSs**) is:

> "*rights of a retail client in connection with an IDPS to which, but for this regulation, Part 7.8A of the Act would not apply*".

The phrase "rights of a retail client in connection with an IDPS" could be interpreted broadly, and its coverage could potentially extend to rights in relation to the underlying financial products that are accessed by retail clients via an IDPS. The FSC understands that this item is intended to require IDPS operators to make a TMD in relation to the offer of the interest in the IDPS itself, and not the underlying financial products which are made available through

the IDPS (and which of course may have their own TMD). We note that the Draft Explanatory Statement to the Draft Regulations (**Draft EM**) indicates on page 8 that relevant platform operators "are not required to make a target market determination in relation to financial products offered or available on their platform (unless they themselves are the issuer)", however "they are required to make a target market determination in relation to the platform itself (as the platform is a separate financial product)". To make this clear and avoid any unintended consequences of IDPS operators being required to make a TMD in relation to the underlying financial products that are accessible through the IDPS, the FSC requests that item 4 of the table is amended to:

> "*a retail client's interest in a managed investment scheme that is an IDPS to which, but for this regulation, Part 7.8A of the Corporations Act would not apply*".

FSC recommendation: item 4 of the table be amended as above.

2.2 Employer default superannuation funds

The scope of the DDO captures employers who nominate their employees to join a default superannuation plan or provide superannuation information (such as a PDS) to their employees. This is explained in detail in Attachment B, and a summary is set out below.

Where an employee has not chosen a superannuation fund ***and*** not made an investment choice, they will be placed in a MySuper product, and the exemption from the DDO obligations will apply. However, where the employee has not chosen a superannuation fund ***but*** makes an investment choice in the default fund before the first contribution is received, then the employee may not be placed in a MySuper product and the TMD requirements should have applied when the employer enrolled them in the default fund.

Given that testing whether the employee is in the target market happens before the employer or trustee knows if an investment choice will be made, employers will have to assume ***all*** employees could make an investment choice. Therefore employers will need to assess whether each employee it enrols in the relevant superannuation product of their Employer Default Fund is within the target market.

The employer placing the employee into the default fund will, under s994A, be engaging in 'retail production distribution conduct', meaning the employer must:

- take reasonable steps that will (or likely will) result in the distribution conduct being consistent with the TMD for the superannuation product within the Employer Default Fund;
- keep records of complaints it receives about the superannuation product;
- report significant dealings; and
- report instances where employees enrolled in the superannuation product as a result of actions taken by the employer are not in the target market.

The burden from these requirements is unreasonable and unwarranted:

- Superannuation guarantee (**SG**) payments are mandatory, not discretionary, for employers.
- Under SG legislation, employers must choose a default fund for employees who do not choose a fund, and then must contribute to that default fund for each employee that does not choose another fund.
- Industrial awards can significantly limit employer choice of default fund.
- If an employee is not within the target market for the superannuation product, then the employer is likely to be either in breach of the Superannuation Guarantee (Administration) Act 1992 or the DDO regime.
- If a TMD for a superannuation product does not cover every potential employee, then in some cases employers may be forced to limit diversity in the workplace to ensure employees meet the TMD. This would be an unintended and undesirable consequence of the DDO regime.
- Judging whether an employee fits within a TMD will be outside the skillset of most, if not all, small business employers.
- Employers are conduits of information related to the employees' superannuation.
- Employer-sponsors are exempted from the requirement to hold an Australian financial services licence (AFSL) relating to this activity.

The FSC notes the Draft Regulations exempt eligible rollover funds (**ERFs**) and defined benefit interests from the TMD requirements. The arguments for exempting employer default funds are very similar:

- ERFs are exempt because they are "required by law" and operate "where contact has been lost with the account holder" (draft EM at page 11). Similarly, employer default funds receive SG payments required by law in respect of potentially disengaged members who fail to choose a super fund.
- Defined benefit interests are exempt because they "are only available through employer arrangements. As such, it is unlikely that such interests are inappropriately distributed" (draft EM at page 12). Similarly, employer default funds are only available through employer arrangements and it is similarly unlikely they are 'inappropriately distributed'.

Therefore, the FSC submits employers also should be exempted from the DDO regime in relation to making available employee benefits which employers are required by law (including an award or enterprise agreement) to provide.

The FSC requests that employer default funds are added to the list of financial products for which a TMD is not required, as item 14 to the table in Draft Regulation 7.8A.04 as shown below:

Item	**Column 1 Topic**	**Column 2 Kind of financial product**
14	Employer Default Fund	An interest in a superannuation product to which a standard employer sponsor (with the meaning from section 16 of the Superannuation Industry (Supervision) Act 1993) of that superannuation fund contributes.

If the intention is that the DDO obligations do not apply to employers, then the FSC submits that the DDO regulations or an amendment to the Corporations Act should be made to reflect this intention.

FSC recommendation: the list of financial products for which a TMD is not required (in Draft Regulation 7.8A.04) should be extended to add employer-sponsors as suggested above, also see Attachment A, at item number 3.

The FSC also requests that consideration be given to amending the scope of regulated persons for the purposes of the DDO, for consistency with the employer-sponsor exemption for AFSLs, see Attachment A, at item number 4.

If, on the other hand, the policy intention is for employers to be captured, this will impose a substantial compliance and cost burden on most, if not all, Australian employers, including small business. This was not a situation or consequence that was identified during the DDO regime consultation, and the FSC expects many small businesses and their representative organisations would be concerned that this new regulatory impost is being imposed on them without reasonable consultation or warning.

If the policy intention is that employer sponsors are included in the DDO regime, the FSC requests that a publicity campaign is commenced as soon as possible, to alert all employer-sponsors to the fact that:

- they will be subject to the DDO regime in connection with giving effect to the superannuation benefits provided to employees as an incident of the employment relationship; and
- that they need to prepare systems and processes to implement the DDO regime, a contravention of which may result in a broad range of criminal and civil penalties.

While there is a reasonable level of awareness of the DDO in the financial services sector, most if not all employer-sponsors outside this sector will be unaware that they need to comply with the DDO regime in relation to superannuation of employees and they will not be preparing for it.

3 Other proposed amendments to the Draft Regulations

The FSC submits the Draft Regulations should be expanded to address a number of important issues considered below.[1]

The FSC proposes these amendments to remove unintended consequences and align the provisions of Part 7.8A with their policy intent as expressed in the revised explanatory memorandum to the *Treasury Laws Amendment (Design and Distribution Obligations and Product Intervention Powers) Bill* 2019 (**EM**).

[1] Some of these requests were included in the FSC's submission on the DDO of 15 August 2018. See: https://treasury.gov.au/sites/default/files/2019-03/c2018-t312297-Financial-Services-Council.pdf

These issues could be addressed through the DDO regulations. However, we note they could also be achieved through amendments to the legislation and that there are two general regulation making powers in the Corporations Act: sections 1364(1) and 1368.

3.1 Excluded dealing relating to personal financial advice

The FSC considers that imposing DDO obligations in situations where consumers already receive significant protection through the regulation of personal advice amounts to unnecessary duplication, inefficiency and cost.

Paragraph 1.84 of the EM states: "While retail product distribution conduct includes providing financial product advice, the new [DDO] regime excludes personal advice and associated conduct from most of the new distribution obligations."

This exclusion reflects that personal advice already involves consideration of the client's individual circumstances and is subject to the best interest and other obligations under Part 7.7A of the Corporations Act. The FSC submits that the definition of 'excluded conduct' in the legislation does not reflect the Parliamentary intention because the definition is limited and does not extend to the following situations.

3.1.1 Issues and regulated sales to retail clients due to personal advice

Issues and regulated sales to retail clients as a result of personal advice under the DDO regime are regulated as 'retail product distribution conduct' and will not be subject to the 'excluded conduct' exemptions in sections 994C(3)-(7), 994D(d), 994E(1) and 994E(3).

By contrast, under the current definition of 'excluded dealing' in section 994A(1), a person 'arranging' for an issue or a regulated sale of a product to a retail client for the purpose of implementing personal advice given by that person (or their associate) is expressly subject to the 'excluded conduct' exemptions in sections 994C(3)-(7), 994D(d), 994E(1) and 994E(3).

FSC members assume that this divergence in approach is an unintended consequence of the definition of 'excluded dealing'. There appears to be no policy reason to exempt 'arranging' dealings but not the dealings themselves in a personal advice scenario, given that the significant protection afforded through the regulation of personal advice applies to both 'arranging' dealings and to the dealings themselves.

3.1.2 Dealings following personal advice from a non-associated adviser

A large proportion of retail financial products are held via platforms where advice is provided by a third party entity which is not an associate of the platform provider. Similarly, financial advice dealer groups and financial advisory intermediaries are a common distribution channel for financial products to be directly distributed to retail clients.

This could include a situation where an adviser recommends a portfolio of investments through a platform, then arranges for the investments (the subject of the personal advice) to be acquired by the platform operator and accessed by the retail client through the platform. This process is repeated each time that further personal advice is received by the client.

The FSC submits in this example that all the dealings undertaken by the platform operator (the regulated person) in order to give effect to the personal advice, also should be characterised as 'excluded dealings'. However, under the current definition they would not be because the regulated person is not an associate of the adviser providing the personal advice.

Therefore, we submit the Corporations Act should be amended (or a regulation made) to broaden the definition of excluded conduct (see s994A of the legislation) to include these situations, by inserting the blue underlined text as marked up below:

> ***'excluded dealing'*** means a dealing in a financial product that consists of an issue or regulated sale of a product to a retail client or arranging for a retail client to apply for or acquire the product, where the issue, regulated sale or arranging is undertaken:
> (a) by a person, or by an associate of a person or by another regulated person; and
> (b) for the sole purpose of implementing personal advice that the person or another regulated person has given to the retail client.

FSC recommendation: The definition of 'excluded dealing' should be amended as suggested above, also at Attachment A, item number 2.

3.2 Personal advice definition

The FSC submits the DDO regime amendment to the definition of personal advice under section 766(B)(3A) does not go far enough, and therefore does not provide adequate exemption for DDO regime activities from personal advice.

This section of the legislation states "However, the acts of asking for information solely to determine whether a person is in a target market…for a financial product, and of informing the person of the result of that determination, do not, of themselves, constitute personal advice" [underlining added].

The FSC notes issuers and distributors will interact with investors in relation to a range of matters, where enquiries may be more than 'solely' to determine if the person is in a target market. For example, they may be asking questions about a client's personal circumstances to determine whether the person complies with a privacy policy or some other internal policy – a reason completely unrelated to providing personal advice but nonetheless a reason in addition to determining whether the person is in a target market.

Also, the actions of issuers and distributors after having asked for information, may require them to then 'consider' information they receive in relation to the personal situation, objectives and needs of the investor, and that 'consideration' activity is not exempted under section 766(B)(3A). This is because the exemption is limited and applies only in relation to acts of 'asking for information' and 'informing' but does not exempt 'considering' the information provided in response.

This means that the act of asking for information 'solely for the purpose of determining whether the person is in the target market' does not constitute the provision of personal advice, but that considering and acting on the information provided in response arguably will still constitute personal advice.

We understand that the intention was to provide some certainty that taking steps to comply with the DDO regime of itself could not amount to personal advice. Therefore, the FSC requests that section 766(B)(3A) be amended by deleting the red struck through text and by inserting the blue underlined text as marked up below:

> "However, ~~the acts of asking for information solely to determine whether a person is in a target market (as defined in subsection 994A(1)) for a financial product, and of informing the person of the result of that determination, do not, of themselves, constitute personal advice~~ personal advice is not given or directed to a person (including by electronic means) to the extent that the provider of the advice has considered one or more of the person's objectives, financial situation or needs in performing, or seeking to perform, one or more obligations imposed on the provider pursuant to Part 7.8A."

FSC recommendation: Section 766(B)(3A) be amended as suggested above, also at Attachment A, item number 1.

3.3 Listed Investment Products and Exchange Traded Products

The FSC submits that there is considerable uncertainty under the DDO regime in relation to the treatment of exchange traded products (**ETPs**), including listed investment companies, listed investment trusts and exchange traded funds (**ETFs**).

The Draft EM states that the distribution obligations:

> "do not apply to trading of products on secondary markets because such trading behaviour does not trigger an obligation to prepare a disclosure document. In some cases, however, the primary issuance of a [product] can occur through a secondary market via an indirect issue which may trigger the obligations under the DDO regime if they are covered by the provisions relating to indirect issues in the Corporations Act (subsection 1012C(6))".

This policy approach is intended to be captured by Draft Regulation 7.8A.02(2), which affects the meaning of "regulated person" in subsection 994A(1) of the Corporations Act to capture sales amounting to indirect issues.

3.3.1 Issue: difference in treatment between closed-ended and open-ended vehicles

As proposed, Draft Regulation 7.8A.02(2) leads to a divergence in regulatory treatment between closed-ended listed vehicles, such as listed investment companies and trusts, and open-ended quoted vehicles such as ETPs. The FSC members submit that there is no policy reason to support such a difference.

The divergence arises because secondary market trading in ETPs, while substantially carried out directly between clients, is also partly facilitated by authorised participants and market makers creating (or redeeming) units on a daily or ad hoc basis. Draft Regulation 7.8A.02(2) appears to capture these market participants as "offerors" and therefore

"regulated persons". For closed-ended listed vehicles, however, *all* trading after the primary issuance is carried out directly between clients. From the client's perspective, there is absolutely no difference in their secondary market trading experience between open-ended and closed-ended exchange traded vehicles. In addition, clients who trade ETPs on market do not have visibility as to whether their counterparty is another secondary market client or otherwise an authorised participant or market maker.

Accordingly, the FSC submits that:

- there is no policy reason for closed-ended and open-ended exchange traded vehicles to receive different regulatory treatment;
- there is no policy reason to impose distribution obligations on authorised participants or market makers; and
- the imposition of distribution obligations on authorised participants or market makers will create substantial barriers for entry and operation of these essential market participants.

3.3.2 Issue: reasonable steps

The legislation and proposed regulations creates serious practical implications as to what the 'reasonable steps' and distribution obligations will entail for issuers of exchange traded products and other market participants, to the extent they are regulated as offerors/distributors. The current Draft Regulations appear to capture authorised participants and market makers as offerors and therefore regulated persons. This policy approach:

- incorrectly approaches the function that authorised participants and market makers perform to facilitate trading and liquidity on Australian exchanges; and
- overlooks the absence of any relationship between these market participants and retail clients buying ETPs on an exchange.

3.3.3 How ETPs are traded and sold, and why this creates issues under the DDO

- Retail investors will typically access ETPs through an online broker such as Commsec, or through their adviser.
- ETPs are not sold or distributed directly by ETP issuers to retail investors.
- ETP units are created and redeemed by Authorised Participants (**AP**) with the ETP issuer.
- The PDS is prepared for the AP by the ETP issuer in order to facilitate compliance with the secondary sale disclosure provisions (for active ETFs, the PDS is prepared for the end investor instead of the AP).
- APs and market makers then issue and trade units on an exchange and provide liquidity for retail investors.
- Due to this mechanism, ETP issuers will generally have no visibility of the retail investors purchasing their products. Brokers may have limited information on the investors, depending on how much they collect.
- In order for ETP issuers to obtain detailed information on the retail investors purchasing their products, they would need reporting from brokers and other online platforms.

- This would also mean that brokers would need to be obligated to collect more detailed information on their account holders to be able to ascertain whether they are in the target market.
- This provides clear roadblocks for ETP issuers in comparison to unlisted products in adhering to the DDO obligations.
- Further, controlling sales of these products on an open exchange is practically impossible

Note the FSC is not advocating for a 'carve-out' of ETPs from the obligation to make a TMD, rather a legislative acknowledgement that there are no reasonable steps that an ETP issuer can take to ensure distribution of its products is consistent with the TMD. FSC members have been informed that the DDO obligations do not apply to secondary market sales other than certain 'secondary sales'. The FSC seeks clarification that the Government does not intend for the ordinary course of issuing and trading ETP units to be subject to distribution obligations.

3.3.4 Distribution Obligations – regulated person/s

In the ordinary course of business an ETP issuer, as described above, does not engage in retail product distribution conduct as it does not issue ETP units to retail clients directly.

Should the distribution obligations fall on an AP or market maker, this would have serious adverse consequences. These firms are not distributors, rather they provide essential liquidity for the efficient functioning of the market, and are part of the market/trading infrastructure. To impose the DDO obligations on them would be contrary to our understanding of the policy set out in the EM and would detrimentally impact the functioning of the ETP market. We are concerned that imposing DDO obligations on many market makers would cause them to cease providing these services.[2]

Should the policy intent be that brokers (such as Commsec, NabTrade etc.) are distributors on an execution only platform, this could only be complied with if these persons were required under the DDO regime to collect and report on trade and client information.

3.3.5 Proposed change

FSC members support issuers of ETPs developing and disclosing a TMD and complying with related TMD obligations, such as maintaining appropriate records. However, it will prove challenging, if not impossible, on a practical level for ETP issuers and market participants to take steps so that the distribution of ETPs is reasonably likely to result in retail product distribution conduct which is consistent with the TMD. ETP issuers have little to no ability to control, and do not have visibility of, who is purchasing the products on the secondary market (be that directly, through a broker or adviser).

In Europe and the United Kingdom under MIFID II, ETPs and listed products are treated differently from other products and this has worked on a practical level. APs and market

[2] Noting ASIC has recognised the importance of market makers in the 2018 report, Review of exchange traded products – Report 583.

makers are not considered distributors on the basis that they perform an infrastructure role (i.e. enabling the secondary market to function) with respect to the product type.

FSC members consider issuers of listed products and ETPs should produce and disclose a TMD for all products. However, the reasonable steps and distribution obligations should not and cannot apply to sales of products on secondary markets (including those sales facilitated by APs and market makers).

FSC recommendations: Noting the Draft Regulations and explanatory material have clarified that secondary market trading is not within scope of the DDO requirements other than for certain 'secondary sales', the FSC recommends:

- the legislation and explanatory material is clarified to ensure that the ordinary mechanism for offering ETP units on market is not within scope, or
- the definition of retail product distribution conduct should be amended as suggested above and as proposed in Attachment A, item number 5.

Further, regulated persons engaging in ETP and listed products sales by an "execution only" model should not be required to comply with the "reasonable steps" requirement. As under MiFID II, Authorised Participants should not be classified as distributors, and this should also be clarified in the Draft Regulations.

3.4 Reasonable steps relating to personal advice

Section 994E(3) places distribution obligations on regulated persons subject to an exception for excluded conduct so that personal advice providers do not have design or distribution obligations under the DDO, except with respect to record-keeping. The FSC supports this exclusion from the DDO regime but considers the exclusion should be expanded to cover situations where the regulated person is aware a person has received personal advice.

The FSC submits that if, after making reasonable inquiries, the regulated person is aware that a client has received personal advice, this should provide sufficient consumer protection and not warrant any further steps to be taken.

An expansion to cover such advised clients will reduce unnecessary duplication (and so inefficiency and wasted costs) in regulatory obligations between regulated persons and personal advice providers. It will significantly reduce uncertainty for regulated persons, particularly platform operators, about the reasonable steps that must be taken, especially when a platform operator reasonably believes that a client has received personal advice but the client has not received the advice or the platform operator is unaware of the details of the advice given.

This issue is particularly relevant for platform operators, who:

a) distribute a wide choice of products to a wide range of clients who are often advised by other, third party, regulated persons and whose personal circumstances, situation and needs are not known to the platform operator; and

b) have limited opportunity to adapt reasonable steps in respect of each product on a given menu.

An expansion of the personal advice exception for reasonable steps to cover more advised situations will assist in the following situations:

- A platform operator could rely on representations or certifications from a financial adviser that an on-platform investment by their client is being undertaken on the basis of personal advice provided to the client.
- Platform operators would not be deterred from accepting applications for products from an advised client due to concerns about the further reasonable steps the platform operator would need to take under the DDO regime in relation to the distribution conduct by another regulated person; and
- Where there is no relationship between the issuer of a product and the adviser to a client in relation to a range of products on a platform menu, the issuer's attempts to regulate the retail product distribution conduct would be ineffective and inefficient.

Therefore, the FSC submits that section 994E(6) should be followed by the following:

> "A regulated person will not be taken to have failed to take reasonable steps for the purpose of paragraph (3)(d) if the person engages in retail product distribution conduct after having made all enquires (if any) that were reasonable in the circumstances and believed on reasonable grounds that the acquisition of the relevant financial product was made in reliance on the provision of personal advice by a regulated person."

FSC recommendation: section 994E(6) is supplemented as suggested above, also at Attachment A, item number 7.

3.5 Wholesale clients definition

The DDO regime excludes wholesale clients from its operations.

The exclusion therefore applies to clients who meet these wholesale client threshold criteria:

- businesses (comprising employees of 20 or more people) or manufacturing businesses (comprising 100 or more); or
- a trustee of a superannuation fund with net assets of not less than $10M.

The wholesale exclusion would therefore apply where a group insurance policy is being issued to a client that is within the above criteria.

Wholesale group policies commonly have these attributes:

- They are arranged through broker channels, whereby the broker acts on behalf of the employer or fund to help obtain the group insurance policy that is appropriate to meet the needs of that business or fund;
- The employer or fund is not the distributor;

- The policies are obtained to meet the employer or fund obligations by law, award or enterprise agreement;
- The end beneficiaries are employees or members who are third party beneficiaries under the insurance policy;
- Employees or members move in and out of coverage under the insurance policy, dependent on their employment or membership status; and
- For policies issued to employers, the insurance is funded by the employer as an employee benefit.

3.5.1 Group policies to employers and funds under the threshold requirements

Group insurance policies are also issued to smaller businesses or funds that are under the required employee or asset thresholds, and therefore fall outside of the definition of wholesale client.

However, these smaller businesses and funds operate in the same way as wholesale clients. For smaller businesses and funds, the policy is arranged with the assistance of brokers who ensure insurance policies meet the needs of that employer or fund. The intention is the acquisition of the policy is to cover a number of beneficiaries and not individuals.

The attributes we refer to above for wholesale clients equally apply to these category of clients. In practice, insurers and brokers undertake the same process for issuing and distributing a policy to large businesses and funds they do for small businesses and funds.

3.5.2 Risks and Concern

Group insurance policies issued to smaller businesses or trustees of funds with less than $10M in net assets make up only a small portion of the entire group insurance market.

Significant risks arise if the DDO applies to this segment:

- insurers may decide to exit this segment of the market as the costs associated with complying with the DDO on an ongoing basis may outweigh the benefits;
- brokers may also exit this segment where the distribution obligations that arise and the need to report to the insurer in relation to distribution matters may be perceived to be (or will) outweigh the benefit.

Brokers play a significant advice role to this segment and the service often extends to insurance administration services by the broker for the business or fund.

We believe the risk of brokers exiting this segment is not a small one given there are no current broker to insurer reporting or monitoring requirements associated with the distribution/sale of any policy.

Ultimately, this may result in small businesses and funds being unable to secure a group life insurance policy for their employees or unable to secure advice and appropriate administrative servicing in relation to the insurance needs of employees or members.

FSC recommendation: Group insurance policies issued to small businesses and funds with less than $10m in net assets should be treated in the same manner as group policies issued to a wholesale client.

We would recommend that a carve out be included in the Regulations so that any group insurance policy issued to an employer (regardless of the number of employees) or a trustee (regardless of the amount of net assets) be treated as if it were issued to a wholesale client for the purpose of the DDO legislation.

3.6 Target market self-assessment

Section 994B(8) states a TMD must be such that it would be reasonable to conclude that:

a) the person acquiring the financial product would likely be in the target market; and
b) the product would likely be consistent with the likely objectives, financial situation and needs of the retail client.

The operation of this section will require reliance on information provided by the investor, particularly where the issuer or distributor does not know the client's personal situation and is not giving personal advice.

As the TMD is a public document, the FSC submits it would be reasonable to rely on an investor's self-assessment (for example, in an application form or electronic confirmation made on a website page) that:

a) they are in the target market; or
b) they are not in the target market, and in that case specify the reason why they wish to proceed with the investment.

The FSC proposes that any self-assessment must be meaningful and allow for the investor to undertake an informed and specific assessment of whether they are in the target market. The FSC is keen to work with the Government to develop an approach that permits self-assessment while maintaining the policy intent of the DDO regime.

FSC recommendation: Section 994B(8) should be amended to add a new sentence stating:

"For this purpose, it is reasonable to make such a conclusion if the retail client provides a self-assessment or confirmation that the retail client is in the target market or if they have a reasonable reason to proceed with the investment despite not being in the target market."

See also drafting suggestion in Attachment A, item number 6.

The FSC also recommends the Government work with industry to ensure the self-assessment is consistent with the policy intent of the DDO regime.

4 Attachment A – proposed drafting

766B Meaning of financial product advice

(1) Omit subsection 766(B)(3A), substitute:

> However, personal advice is not given or directed to a person (including by electronic means) to the extent that the provider of the advice has considered one or more of the person's objectives, financial situation or needs in performing, or seeking to perform, one or more obligations imposed on the provider pursuant to Part 7.8A.

994A Definitions

(2) Omit the definition of ***excluded dealing*** in subsection 994A(1), substitute:

> ***excluded dealing*** means a dealing in a financial product that consists of an issue or regulated sale of a product to a retail client or arranging for a retail client to apply for or acquire the product, where the issue, regulated sale or arranging is undertaken:
>
> (a) by a person, or by an associate of a person or by another regulated person; and
>
> (b) for the sole purpose of implementing personal advice that the person or another regulated person has given to the retail client.

(3) Add the following to the table in Regulation 7.8A.04:

Item	**Column 1 Topic**	**Column 2 Kind of financial product**
13	Employer Default Fund	An interest in a superannuation product to which a standard employer sponsor (with the meaning from section 16 of the Superannuation Industry (Supervision) Act 1993) of that superannuation fund contributes.

(4) Omit paragraph (b) in the definition of regulated person in subsection 944A(1), substitute:

> (b) a regulated person as defined in section 1011B (modified so that the references to financial products include references to securities and modified to exclude an employer-sponsor arranging for the issue of a superannuation product to an employee);

(5) Omit paragraph (a) of the definition of ***retail product distribution conduct*** in subsection 994A(1), substitute:

> (a) dealing in the product (other than dealing in a financial product that is quoted on a prescribed financial market and which occurs in accordance with the operating rules of a clearing and settlement facility) in relation to a retail client;

(6) **After subsection 994B(8)**

Insert:

For this purpose, it is reasonable to make such a conclusion if the retail client provides a self-assessment or confirmation that the retail client is in the target market or if they have a reasonable reason to proceed with the investment despite not being in the target market.

(7) **After subsection 994E(6)**

Insert:

(7) A regulated person is also not taken to have failed to take reasonable steps for the purpose of paragraph (3)(d) if the person engages in retail product distribution conduct after having made all enquires (if any) that were reasonable in the circumstances and believed on reasonable grounds that the acquisition of the relevant financial product was made in reliance on the provision of personal advice by a regulated person.

5 Attachment B – DDO and Employer Default Superannuation

5.1 Employer sponsored superannuation

A typical employer sponsored superannuation plan has a MySuper product or investment option and all new members who do not make any investment choice in the plan are invested in this product or option by default (for the remainder of this attachment, 'product' covers 'investment options').

A typical employer sponsored superannuation plan also offers a number of Choice products and insurance options (e.g. additional cover, no cover).

Typically, there is a single PDS covering the MySuper product and all the Choice products for the plan. Generally, each employer group in a superannuation fund has their own plan, so there may be many employer plans in a super fund.[3]

Under the Corporations Act, the "product" (ie the interest in the superannuation fund) is issued when the member first joins that plan.[4] Under the Corporations Act, another "product" is issued if the member later chooses to take a pension[5] or changes to another plan in the superannuation fund. Under the DDO regime, it is at these points that the trustee needs to be satisfied that the person is likely to be in the target market set out in the TMD.[6]

Once in the plan, a member can make new investment and/or insurance choices at any time and can switch between MySuper and Choice products. Under the Corporations Act, ***the member does not acquire a new product by making these choices and no PDS is required to be given to the member***. Under the DDO regime, whether a member is likely to be in the target market is tested at the time the member ***joins*** that plan (ie acquires that product)[7] and not at other ***later*** times – such as when the member makes subsequent investment or insurance choices (that don't require a PDS to be given to the member) or when a member switches between MySuper and Choice products.

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[3] This is because most employer plans are created when the members and assets of the employees of that employer are moved to this fund by way of a successor fund transfer under SIS Regulation 6.29. This requires the member rights in the new fund to be "equivalent" (SIS Reg 1.03(1) "successor fund"). To do this, the new fund generally sets up a new plan for that employer's members with features that are equivalent to or better than the transferring fund. This means that each of the employer plans in a fund are likely to be different.

[4] *Corporations Act 2001* section 761E(2) and (3).

[5] 7.1.04E of the *Corporations Regulations* 2001.

[6] This could be clearer in the *Treasury Laws Amendment (Design and Distribution Obligations and Product Intervention Powers) Act 2019* (**DDO Act**), however in the Explanatory Memorandum to the DDO Act it is clear that the intent of the DDO legislation is to test product suitability for retail customers at the point of sale (ie when the product is initially acquired).

[7] section 994A of the DDO Act definition of "retail product distribution conduct" and section 994E(3).

5.2 Members are disengaged

Some members ***choose*** to join a superannuation plan. Whether they are in the target market will be tested at the time the member chooses to join that plan.

But in most cases, a member joins a fund when their employer enrols them in the employer's plan. That is, most employees are disengaged and do not choose a superannuation fund.

- The 2009 Cooper Review found 80 per cent of superannuation fund members were invested in the default fund chosen by their employer. Of that 80 percent, anecdotal evidence suggested that about 20 percent explicitly chose the default option, with the rest making no active choice whatsoever.[8]

Employers must make superannuation guarantee (**SG**) contributions for their employees.[9] Where an employee hasn't chosen their own fund, the employer must make the SG contributions to the fund chosen by their employer (**Employer Default Fund**).[10] Penalties apply to the employer if they don't comply with these rules.[11]

Importantly, an employee becomes a member of the Employer Default Fund without any positive action by the employee member. But these members are not necessarily MySuper members.

Where an employee member has not chosen their own fund ***and*** has not made an investment choice, then that employee member is registered with the MySuper product in the Employer Default Fund[12] (The TMD requirements don't apply to MySuper products).

But where an employee member has not chosen their own fund ***but*** makes an investment choice, then the TMD requirements apply.

Very importantly, at the time that the DDO regime requires the testing of whether the member is in the Target Market[13] – ie at the time the employer enrols them in the plan – neither the employer nor the Trustee know if that member (once enrolled in the plan) will make an investment choice or not. So, at the point of enrolment, it is not known if the member will make an investment choice and be subject to the DDO regime.

Once enrolled in the plan, the member is sent a member number and can make investment, insurance and other choices. If the member elects to invest only in Choice options in the plan before the first contribution is received from the employer, then the member will not

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[8] See: https://www.pmc.gov.au/news-centre/pmc/nudged-behavioural-insights-public-policy
[9] Superannuation Guarantee (Administration) Act 1992 ('SGA Act')
[10] SGA Act section 32C.
[11] SGA Act Part 6
[12] SIS Act section s29WA
[13] Putting the employee into the Employer Default Fund would be "retail product distribution conduct" under section 994A.

become a MySuper member and an assessment of whether they are in the target market should have been done at the time they were placed in the plan by their employer.

But if the member doesn't make an investment choice (or does so after the first contribution is received for them in the plan[14]) then that member will initially be a MySuper member and no target market assessment was needed at the time of enrolment.

Employers must make SG contributions at least every quarter.[15] So, it may be 3 months before the first contribution is received by the plan for a member enrolled by their employer. That is plenty of time for that member to make an investment choice and so not be in a MySuper product.

The problem faced by employers is that they cannot know which employees will or won't make an investment choice. Therefore, to comply with DDO legislation, employers will have to assume that every employee will make an investment choice. This means that an employer will need to assess whether each employee it enrols in their Employer Default Fund is within the target market.

As most MySuper members are enrolled by their employer, this makes the MySuper exemption in section 994B(3)(a) largely ineffective. This is clearly not the intent.

5.3 The employer as a distributor of the Employer Default Fund

An employer is responsible for placing employees into an Employer Default Fund. The employer will typically make a copy of the PDS of the Default Fund available to employees (eg. on the employer website, or through HR). As such, the employer will be engaging in "retail production distribution conduct" under section 994A.[16]

This means the employer must:

- take reasonable steps to ensure that the employees they put into the Default Fund fit the TMD for that Employer Default Fund[17] (the difficulties with this are discussed above);
- keep records of complaints it receives about the Employer Default Fund;
- report significant dealings;
- report instances where employees enrolled in the Employer Default Fund by the employer don't fit in the TMD.

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[14] Typically, the member would have received a PDS from the employer (usually at the same time as the notice by the employer under section 32P of the SG Act). A further PDS is not required for a member to then make choices once a member of the plan. This is very different to platform products where the underlying investment products each require PDSs under section 1012IA of the Corporations Act.
[15] SGA Act, Part 3
[16] For completeness, an employer will be a "regulated person" because employer-sponsors fall within para (f)(ii) of the definition of regulated person in s1011B by virtue of their Australian financial service licence exemption under s911A(2)(k) and Corporations Regulation 7.6.01(1)(hc).
[17] Section 994E(3).

In our view, employers will be unaware that they will have these obligations and to impose these obligations on them is an unreasonable burden – particularly for small business.

It is an unreasonable burden because:

- Every employer in Australia must pay SG for its employees. It is not discretionary.
- Due to industrial awards, many employers have limited choice as to their Employer Default Fund.
- If an employee does not fit within the TMD for the Employer Default Fund, (and so the employer cannot put that person in the Employer Default Fund) the employer risks penalties under the SG Act[18] and penalties for breach of the award (where the award specified that fund).
- Employers typically employ diverse work forces - diversity of race, religion, gender, age, income, tolerance of risk, disability, education etc. This is encouraged by government policy and supported by anti-discrimination legislation. An unintended and undesirable consequence of the DDO legislation may be that employers limit diversity in their workforce to only those employees that neatly fit within the TMD for the Employer Default Fund.
- Employers, particularly small businesses, are generally not financial services experts. Their core skills and expertise are in the products and services that they sell to market. Employees that employers will enrol in the Employer Default Fund are disengaged (which is why they haven't chosen a fund for themselves). The employer won't necessarily have the information about those employees or the skills or experience to judge whether that person fits within the TMD for the Employer Default Fund.
- ATO statistics show that unpaid SG is mostly for employees of small business[19] and employer uncertainty around whether particular employees fit within the TMD of the Employer Default Fund is likely to increase this trend.

5.4 Like ERFs and defined benefit interests

The Draft Regulations exempt eligible rollover funds (**ERFs**) and defined benefit interests from the TMD requirements.

[18] Section 32C requires the employer to make the contributions to the Employer Default Fund in the notice given to the employee under section 32P. While the employer could choose a different Employer Default Fund (and give a new section 32P notice) for that employee once the employer become aware that that employee doesn't fit within the TMD for the first Employer Default Fund, in doing so, the employer may be outside the time requirements to make SG contributions for that employee and/or in breach of section 32N(2) requiring the valid section 32P notice to be given within 28 days of employment commencing.

[19] ATO (2018) 'Super guarantee system': https://www.ato.gov.au/About-ATO/Research-and-statistics/In-detail/Tax-gap/Superannuation-guarantee-gap/?page=2

In the Draft EM, ERFs are exempted because they are "*required by law and operate in circumstances such as where contact has been lost with the account holder*" therefore "*it is not necessary to apply the DDO regime to them.*"[20]

This is similar to Employer Default Funds:

- employers are required by law to make SG contributions;
- unless the member chooses a fund, those contributions have to be made to the nominated Employer Default Fund (which may be prescribed in an award); and
- those employees are likely disengaged.

Similarly, the Draft EM states that defined benefit interests are exempt because "Offers of defined benefit interests are only available through employer arrangements. As such, it is unlikely that such interests are inappropriately distributed."[21]

Employer Default Funds are also "only available through employer arrangements." And it is similarly unlikely that they "are inappropriately distributed".

[20] Page 11
[21] Page 12