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Time to act: design and distribution obligations

The Design and Distribution Obligations (***DDO***) regime is the biggest of the many big new things for the financial services industry in 2020. The legislation was passed in the first half of 2019 (in the *Treasury Laws Amendment (Design and Distribution Obligations and Product Intervention Powers) Act 2019* (Cth)). Regulations were made in December 2019, and ASIC issued its draft Regulatory Guide and consultation paper in late 2019, just before Christmas (which is becoming the traditional season for regulatory consultation). You have until 11 March 2020 to let ASIC know what you think.

It all kicks off on 5 October 2021. Given the work involved to comply, that is not very far away. The regime will apply to issuers of most types of financial products – think ASIC Act, the National Consumer Credit Protection Act and Chapter 7 of the Corporations Act, and distributors – this is a new concept and extends beyond licensees and their representatives. The regime will affect almost every part of the financial services industry – including banks and other credit providers, superannuation providers and insurers.

PRODUCT ISSUERS

Broadly, an issuer of a financial product for the purposes of Part 7.8A is a person who must prepare a prospectus under Part 6D.2 of the Corporations Act for the product; a product disclosure statement (***PDS***) under Chapter 7 of the Corporations Act; or the issuer of the financial product under Division 2 of Part 2 of the ASIC Act (credit facilities).

If you are the issuer of a financial product, you must (in short):

- make a 'target market determination' for each product the regime covers;
- take reasonable steps that will, or are reasonably likely to, result in 'retail product distribution conduct' (other than certain excluded conduct) being consistent with the determination;
- notify ASIC of 'significant dealings' in a product in relation to a retail client that are inconsistent with the determination; and
- review the determination regularly and keep records.

A target market determination must, among other things, 'describe the class of retail clients that comprise the target market (within the ordinary meaning of the term) for the product'. We can't help but wonder whether 'target market' has an ordinary meaning; in any case, the target market for a product comprises that group of retail clients for whom the product 'would likely be consistent with the possible objectives, financial situation and needs of the retail client'. According to ASIC, 'this involves identifying a class of consumers based on the common aspect of their objectives, financial situation and needs', but not too common. ASIC says that a target market must be identified with 'sufficient granularity' and that an issuer would breach its obligations if 'it defined the target market too broadly'.

WHICH FINANCIAL PRODUCTS ARE COVERED?

A target market determination must be made for a product if a prospectus or a PDS is required. This includes some deposit products (term deposits, primarily), and certain other products banks issue to retail clients, such as hybrid securities and derivatives. A target market determination is also required for basic deposit products (which are exempted from the PDS regime but that the DDO regulations include).

A target market determination is also required for most credit products. This may come as a surprise to a few people given that credit products (including margin lending products) were originally excluded. This was because they are subject to specific consumer protection rules, such as the responsible lending obligations.

The Bill was subsequently amended to extend the DDO regime to all financial products covered by the ASIC Act's unconscionable conduct and consumer protection provisions (other than those that are also financial products for the purposes of Chapter 7 of the Corporations Act, or are excluded by regulations). This brought most credit products into the regime, including those covered by the National Credit Code. →

Which financial products are covered?

- Basic banking products
- Choice super products
- Platforms
- Hybrid securities
- Derivatives
- Credit products (excluding margin lending products)

- My super products
- Margin lending facilities
- Licenced pawnbroking
- Closed products

Preparing for DDOs

WHO	Issuers of most types of retail financial products and credit products.	Distributors of most types of retail financial products and credit products.
PROPOSED CHANGES	Product issuers must make a target market determination (TMD) for each product the regime covers.	Product distributers must make reasonable inquiries and believe that a TMD is made and is current before distributing.
	Product issuers must monitor and review TMD and adjust when applicable, and must monitor distribution and align with TMD.	Product distributers must keep records of TMD compliance.
WHAT ORGANISATIONS NEED TO DO NOW	Organisations have just over a year to comply, and need to understand the impact of the coming changes.	
	Understand the TMD and other obligations and create a consistent approach to apply them.	
	Consider what kind of systems and controls need to be made to promptly notify ASIC of any significant inconsistent dealing.	
	Issuers may need to renegotiate distribution contracts.	
	Distributers need to consider their product TMD against their customer base, and change their product offering if applicable.	

But it still leaves out margin lending facilities, which are Chapter 7 financial products. There is no apparent justification for treating these products differently and the outcome is anomalous, given the comparative riskiness of margin lending products, compared with simple credit products such as unsecured personal loans.

The regulations have also specifically excluded the following credit facilities from the DDO regime:

- credit facilities, other than those issued in the course of a business that is wholly or partly a business of providing credit;
- credit facilities required to be applied wholly or predominantly for business purposes;
- certain credit facilities that do not involve a deferred debt;
- the provision of a mortgage that secures obligations under a credit contract (but not the credit contract); and
- the provision of credit by a pawnbroker in the ordinary course of a legal pawnbroking business.

Closed products that are not issued or sold to consumers after the commencement date are generally excluded.

PRODUCT DISTRIBUTORS

A distributor is a person who engages in 'retail product distribution conduct'. A person will engage in retail product distribution if they deal in the product for a retail client, give a prospectus to a retail client, give a PDS to a retail client or provide financial product advice to a retail client. This might seem straightforward but is not. Most of you will be acutely aware of the difficulties in distinguishing financial product advice from, say, information. Plus, the DDO regime gets really hard when the products are not Chapter 7 financial products. This is because Part 7.8A applies all of the Chapter 7 concepts to things that are not Chapter 7 financial products, by instructing the reader to 'treat a reference in [the Corporations] Act to a financial product as being a reference to a financial product within the meaning of [Part 7.8A]' when 'determining the meaning of a term used in [Part 7.8A]'. This means it is possible, for the purposes of Part 7.8A, to 'deal' in (issue, arrange for the issue and so on) a loan and to give financial product advice about a loan, but that none of the obligations attaching to dealing in a financial product or providing financial product advice under Chapter 7 will apply to that person when they are arranging for the issue of that loan. So much for Commissioner Hayne's call for 'no exceptions'.

What is excluded conduct?

Providing personal advice about financial products

Applying or acquiring a product based on personal advice

Personal advice on credit products (subject to certain conditions)

Leaving aside the difficulties that might arise in working out whether you are, in fact, engaging in retail product distribution, you must, if you are a distributor (again, in short):

- not engage in 'retail product distribution conduct' unless you have made all reasonable enquiries and reasonably believe that a determination has been made for the product (or that it is not required);
- take reasonable steps that will, or are reasonably likely to, result in retail product distribution conduct in relation to the product being consistent with the determination;
- notify the issuer of 'significant dealings' that are inconsistent with the determination; and
- keep records.

EXCLUDED CONDUCT

Most of the obligations that apply to distributors do not apply to retail product distribution conduct that is 'excluded conduct'. Providing personal advice and dealing in a financial product by arranging for a retail client to apply for or acquire a product for the purpose of implementing personal advice the person has given to the retail client, are both excluded conduct.

This makes sense, because a person who provides personal advice is required to provide that advice in the best interests of the client. Accordingly, the adviser should be able to be relied on to decide whether the financial product they recommend is, in fact, suitable for the client, based on the client's actual objectives, financial situation and needs. The revised explanatory statement details that 'excluded conduct' is excluded because 'such conduct already involves consideration of the client’s individual circumstances and is subject to the best interest obligations under Part 7.7A of the Corporations Act'.

But this is where the direction to treat all references to financial products in the Corporations Act as being a financial product for the purposes of interpreting a provision of Part 7.8A doesn't work so well. Personal advice is a form of financial product advice. For most purposes, you can only give financial product advice about a financial product of the usual Chapter 7 kind. But for the purposes of Part 7.8A, you will be deemed to give financial product advice about a financial product if you recommend, say, a home loan (a Part 7.8A financial product). The problem with this (assuming consistent treatment is desirable) is that a lender will be treated, for the purposes of 7.8A and the definition of excluded conduct, as giving personal advice about a home loan if they recommend the home loan and take into account the customer's personal circumstances, but none of the obligations attached to the giving of personal advice in Part 7.7A will apply to them. Unlike the financial adviser, the lender will not, in fact, be subject to the best interests obligations that justify the exception of personal advice from the distribution obligations.

DDO AND RESPONSIBLE LENDING

The responsible lending obligations (which are not a walk in the park) were a justification for originally excluding credit products from the DDO regime. That made sense. But now lenders will have to form a view that their customer falls within the class of person for whom the loan is likely to be suitable (given their likely objectives, financial situation and needs) and that the loan will not be unsuitable for their customer. It's true.

For mortgage brokers, things will be even more complicated – they will have to decide that their client falls within the class of person for whom the loan is likely to be suitable, that the loan is not unsuitable for their client and that the loan is in the best interests of the client. This is all for a product where no particular consumer harm was identified in the Royal Commission.

You might think we are overstating the complexity and that it might be simple enough for lenders (issuers) and distributors to (re-)design their systems and processes so that they efficiently collect information from customers for the purposes of both regimes (or all regimes), and so minimise doubling up of processes. But it is clear the DDO, responsible lending obligations and the mortgage brokers' best interests duty will apply separately and so all will need to be complied with.

ASIC says in its draft Regulatory Guide:

We consider that the reasonable steps required by the design and distribution obligations do not require further steps to be taken by a distributor when assessing, for responsible lending purposes, whether the consumer can comply with their financial obligations under the contract. The reasonable steps obligation under the design and distribution obligations is a 'process and controls' obligation to generally distribute to consumers who are in the target market for a product.

It is not very clear what this means. The information required to confirm whether a consumer is within the target market for a credit facility may not be the same information as is required to be collected to comply with reasonable enquiries and verification obligations under the responsible lending regime, or to confirm whether a loan is not unsuitable.

MORE TO COME

In the next couple of pages some of our team members consider DDO for buy now pay later lenders and for 'fintechs'. It is safe to say DDO will be a brave new world for them.

In our next instalment, we will look at some of the issues that arise in relation to wealth products. In particular, there are more quirks and oddities in the way the regime will apply to platform products (and ASIC's proposals in the draft Regulatory Guide in some ways make life even harder for issuers and distributors).

In the meantime we look forward to your comments.

The Allens DDO team

The DDO regime will require greater scrutiny of the impact of a product on certain market segments, and of whether a product is really appropriate for certain borrowers, or certain marketing channels.

Vulnerable consumers and **small amount credit providers**

Amy Atashi and Kerensa Sneyd

There are many examples of particularly vulnerable consumers having fallen prey to unscrupulous lenders. Their only real remedy turned on whether the product or its distribution was 'unconscionable' and, often, whether ASIC or the ACCC took an interest and decided that they had the power (and will) to take any steps to protect the consumers from the relevant conduct.

By requiring target market determinations and restricting the distribution of products, the DDO regime will codify minimum expectations for all lenders dealing with retail customers and may well go a long way to preventing predatory lending to disadvantaged consumers. This is because it is likely to be quite hard for the lenders with poor products and exploitative products to identify a target market of consumer for whom their product might be suitable. We hope.

BUY NOW PAY LATER

To date, many buy now pay later (***BNPL***) lenders have neatly sidestepped the general conduct obligations applying to providers of credit under the National Consumer Credit Protection Act, as well as the advertising obligations under the National Credit Code.

Subject only really to laws about misleading conduct and unconscionability, BNPL lenders have not had to deal with scrutiny from ASIC (nor APRA) and so have enjoyed much greater freedoms in the design and marketing of their products than other credit providers.

The DDO regime will bring an end to this privileged position. Like other lenders, BNPL lenders will need to consider the impact of their product on their customers and think about how they affect certain market segments. They will need to form a view about whether their product is really appropriate for certain borrowers, or certain marketing channels. The requirement to make public a target market determination will expose decisions to critique under the lens of community expectation. Overly aggressive or damaging market determinations could result in irreparable reputational damage and even boycotts.

The accidental regulator? Has the DDO inadvertently become a means of regulating fintech?

Nicola Greenberg

One of the fascinating elements of the DDO is the way its scope has rapidly expanded as it progressed through Parliament, and how it has been moulded by developments in the financial services environment.

You may remember that the original version of the DDO did not refer to credit as defined by the ASIC Act. However, in February 2019, the Senate Economics Committee released its report on 'Credit and financial services targeted at Australians at risk of financial hardship'. This report contained a chapter that was entirely dedicated to 'Buy Now Pay Later', an emerging fintech product, and concluded with a recommendation that the DDO definition be expanded to cover BNPL products and other credit products, by including 'credit' as defined by the ASIC Act.

As a result, when the Federal Government reintroduced the legislation in the House of Representatives with the expanded definition in April 2019, it contained an explicit reference to the intended effect of capturing credit facilities within the design and distribution regime. With BNPL and, potentially, other credit-based fintechs included, it is interesting →

← to consider how fintechs will comply with the obligations, and how this may change their operations.

Fintechs pride themselves on flexibility, scalability and the ability to adapt to changes in the market. This seems to be a bit of a mismatch with the specificity that ASIC expects under the DDO. Likewise, new entrants to the market struggle with obtaining market share, and often cite a streamline onboarding process as a critical component in enticing new customers. The information required under DDO may slow this significantly, and change the customer experience.

Considering how, as a fintech or an investor in fintech, you would answer the following questions:

- for a new fintech, or one that is scaling rapidly, how often will a target market determination need to be adjusted to reflect its growing and changing product and customer base?;
- what constitutes 'reasonable steps' to ensure the fintech is distributing the product consistently with its determination? Does this mean that typically 'light touch' regulated entities in the BNPL market will need to gather more customer data to satisfy themselves about distribution?; and
- what kind of systems and controls might a fintech need to ensure it can promptly notify ASIC of a significant inconsistent dealing?

Overall, we wonder how much enhancement of the customer data a fintech is collecting will be required, and how this might shape innovation in Australia's financial services market.

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