Australian Banking Association

15 August 2018

Ms Ruth Moore, Manager
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The Treasury
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by email: ProductRegulation@treasury.gov.au

Dear Ms Moore

Exposure draft - Treasury Laws Amendment (Design and Distribution Obligations and Product Intervention Power) Bill 2018

The Australian Banking Association (ABA) welcomes the opportunity to provide this submission on the Treasury Laws Amendment (Design and Distribution Obligations and Product Intervention Power) Bill 2018.

With the active participation of member banks in Australia, the ABA provides analysis, advice and advocacy for the banking industry and contributes to the development of public policy on banking and other financial services. The ABA works with government, regulators and other stakeholders to improve public awareness and understanding of the industry's contribution to the economy and the community, to ensure Australia's banking consumers continue to benefit from a stable, competitive and accessible banking industry.

As noted in submissions on an earlier draft of this Bill, the banking industry supports the intent of the Design and Distribution Obligation (DDO) to assist "consumers select appropriate financial products by requiring issuers and distributors to appropriately market and distribute financial products." We believe that in the context of complex financial products and/or products that carry investment risk, disclosure in isolation can be ineffective. We support the Financial Systems Inquiry Final Report (FSI Final Report) observation that "these issues have contributed to consumer detriment from financial investment failures, such as Storm Financial, Opes Prime, Westpoint, agribusiness schemes and unlisted debentures."

We acknowledge that, in response to stakeholder submissions, the latest iterations of the draft Bill and Explanatory Memorandum include some changes that assist in interpretation of the Bill and clarify some ambiguities that were present in the earlier draft. That said, there are a number of issues that we wish to draw the Government's attention to, and these, together with our recommendations, are set out below.

Key recommendations

Basic deposit products

(a) Basic Products should not be brought into the DDO regime.

(b) If basic products are to be included, the regulations should exclude certain subclasses of products – such as low-cost transaction accounts – that are likely to be suitable for all retail consumers. At a minimum, it should be made clear that ASIC's modification powers extend to defining and excluding

subclasses of products from the regime where it is satisfied that they are likely to be suitable for a very broad range of customer.

Hybrid securities

(a) Hybrid securities should be exempted from the proposed regimes, given the strength of existing regulatory oversight and requirements, and the role of hybrids to meet APRA's regulatory capital requirements for banks.

(b) If hybrid securities are included in the regime:

i. The EM should make clear that the product intervention power should not be applied by ASIC in a manner inconsistent with its own framework for securities issuance, or with the goals and objectives of APRA's prudential capital regime; and

ii. a formal review should be undertaken within two years of inception to determine the impact on the market and whether any changes are necessary.

Debentures of ADIs

The regulations that bring debentures of ADIs into the regime should make clear that wholesale debentures are not to be included.

Secondary market trading

To address residual uncertainty around the application of the regime to secondary sales of financial products and ensure that the intention to exclude secondary sales is clear, the wording used in Treasury's information note should be included in the EM.

Target market determination – clarification of scalability of obligations

The explanatory materials to the Bill, and / or ASIC's guidance, should provide further detail around the scalability of obligations and regulatory expectations for target market determinations, especially in respect of simple products and hybrid securities that are likely to be suitable for a broad range of customers.

Transition and ASIC Guidance

The amendment to make the issuer and distributor obligations take effect two years after the date the Act receives Royal Assent are welcome. However, in order to facilitate timely transition, and to minimise costs, it is critical that the associated ASIC guidance be released in a timely fashion.

Penalties

(a) The Government should review the penalties slated for inclusion for consistency with the principles in the Guide to Framing Commonwealth Offences.

(b) The proposed penalties in the draft Bill should be reviewed for consistency with the level of seriousness of offending behaviour and with other comparable provisions in the Corporations Act.

Personal advice

(a) It should be made clear in the Bill, that the taking of reasonable steps under section 994E does not constitute personal advice under section 766B(3).

(b) The use of the term 'solely' in new subsection 766(3A) should be reconsidered.

Basic deposit products

In our submission on the earlier draft Bill, we made comments on the intention expressed by the Government to make basic deposit products part of the regime through regulation. We note the advice from Treasury that these and other submissions to the same effect have been taken into account, and that it remains the intention of the Government to include basic deposit products.

In those circumstances we will not repeat the extensive submissions previously made. However, we reiterate those points; in particular, we note that the policy intent of the DDO is to overcome the identified deficiencies of disclosure, such as "consumer disengagement, complexity of documents and products, behavioural biases, misaligned interests and low financial literacy." It also intends to reduce the likelihood of failures such as Storm Financial or Opes Prime. It is not clear how, including basic products furthers this objective, nor what the expected benefits for consumers will be. In our view, the inclusion of Basic Products in the DDO regime does not further the stated policy intentions and has the effect of complicating the provision of Basic Products without providing useful consumer protection.

In the most recent consultation round, Treasury noted that the intention of this regime is to make issuers consider which markets are appropriate for particular products. In relation to basic products, Treasury has argued that certain fee structures or product categories – such as term deposits – may not be suitable for all. Even if this point of view were accepted, there remain subcategories of basic products that are likely to be suitable for all customers – an example is no or low-fee transaction accounts.

If basic products are to be brought within the regime, the regulations should exclude subclasses of products that will likely be suitable for all. This would avoid unnecessary cost and complexity brought about by the application of the regime to these products. At a minimum, it should be made clear that ASIC's modification powers extend to excluding subclasses of products from the regime where it is satisfied that they are likely to be suitable for a broad range of customers.

Recommendations

(a) Basic Products should not be brought into the DDO regime.

(b) If basic products are to be included, the regulations should exclude certain subclasses of products – such as low-cost transaction accounts – that will likely be suitable for all. At a minimum, it should be made clear that ASIC's modification powers extend to excluding subclasses of products from the regime where it is satisfied that they are likely to be suitable for a broad range of customers.

Hybrid securities

The government has reaffirmed its decision to include hybrid securities in the design and distribution obligations and product intervention power regimes. In our view, this decision should be reconsidered. Each bank, as an APRA-regulated entity, is required to issue a certain amount of regulatory capital in the form of Additional Tier 1 and Tier 2 securities (known as "hybrid securities") and common equity (ie ordinary shares) in order to safeguard depositors and promote financial system stability. The structure, terms and features, of hybrid securities are designed in compliance with APRA's prudential standards for Additional Tier 1 or Tier 2 capital. There is little flexibility to change product features to accommodate issuer or investor preference. In recent years, the ASX-listed market has been an important source of Additional Tier 1 and Tier 2 capital raising for the Australian banks. Potentially restricting the target market for issuance of hybrid securities, could impact the ability of the banks to comply with their regulatory capital requirements.

The ABA has concerns that the proposed product intervention power will be particularly problematic for listed hybrid securities. After APRA has assessed the capital issuance, these securities are issued under a prospectus, which is subject to review by ASIC for a seven-day exposure period as required under s727(3) of the Corporations Act. In some cases, ASIC will also pre-vet a prospectus prior to launch. ASIC is able to issue stop orders while disclosure is improved, or some other action taken. The ASX also reviews the terms of hybrid securities to ensure terms are appropriate and equitable under its listing rules. The proposed product intervention power, particularly if applied in a way that is

inconsistent with ASIC's current framework, or APRA's prudential regime, may lead to uncertainty and delays, potentially undermining the successful completion of necessary regulatory capital transactions. If a proposed intervention related to a product feature or term assessed by APRA to be necessary for it to qualify as regulatory capital, or to a regulatory capital product in its entirety, it could have a significant impact on the capital positions of the Australian banks.

Recommendations

(a) Hybrid securities should be exempted from the proposed regimes, given the strength of existing regulatory oversight and requirements, and the role of hybrids to meet APRA's regulatory capital requirements for banks.

(b) If hybrid securities are included in the regime:

i. The EM should make clear that the product intervention power should not be applied by ASIC in a manner inconsistent with its own framework for securities issuance, or with the goals and objectives of APRA's prudential capital regime; and

ii. a formal review should be undertaken within two years of inception to determine the impact on the market and whether any changes are necessary.

Debentures of ADIs

We note the intention, expressed in paragraph 1.35 of the EM, to regulate to bring the debentures of an Australian ADI within the scope of the regime. In our view it should be made clear that only debentures offered to retail investors are to be brought within the scope of the regime, and that wholesale debentures – which do not require disclosure on the basis of other available exemptions in the Corporations Act – are not intended to be caught.

Recommendation: Make clear in the regulations that wholesale debentures are not to be included in the regime.

Secondary market trading

The material provided by Treasury confirms the intention that regulated distribution activity does not include secondary sales of financial products, or other variations to or cancellations of financial products (Treasury information note page 3). While we appreciate the clarification of the intention in the information note, in our view it is has not been made clear in the Bill or EM.

Recommendation: To address residual uncertainty around the application of the regime to secondary sales of financial products and ensure that the intention to exclude secondary sales is clear, the wording used in Treasury's information note should be included in the EM:

> A new term 'retail product distribution conduct' has been defined and the meaning of 'dealing' has been narrowed.
>
> The intended effect of these definitional changes is that regulated distribution activity (that is, activity that must be consistent with target market determinations):
>
> - includes providing disclosure documents, providing general advice and dealing;
> - does not include secondary sales of financial products, or other variations to or cancellations of financial products; and
> - only includes activity with respect to retail clients

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Target market determination – clarification of scalability of obligations

We note that Treasury has repeatedly emphasised the Financial System Inquiry's statement that obligations under this regime should be 'scalable' and that 'simple, low-risk products such as basic banking products would not require extensive consideration and may be treated as a class, with a standard approach to their design and distribution.' Nevertheless, further clarity around what is expected would be welcome, and would assist industry in quantifying the costs of implementing the new regime.

Recommendation: The explanatory materials to the Bill, and / or ASIC's guidance, should provide further detail around the scalability of obligations and regulatory expectations, especially in respect of simple products that are likely to be suitable for a broad range of customers.

Transition & ASIC Guidance

The amendment to make the issuer and distributor obligations take effect two years from the date the Act receives Royal Assent are welcome. However, in order to facilitate timely transition, and to minimise costs, it is critical that the associated ASIC guidance be released in a timely fashion.

We note that ASIC has indicated it intends to consult on draft guidance around the time the Act receives Royal Assent. This would be welcome.

Further, such guidance should, to the greatest extent possible, address issues around clarification of regulatory expectations that have been raised during consultation.

These include:

What is necessary to satisfy the requirement in clause 994E of the Bill for the issuer to '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'. Although the term 'reasonable steps' is defined in clause 994E(5), further clarification around the obligation would assist, especially having regard to the fact that non-compliance is an offence. Further clarification could also be provided around questions such as how often target market determinations should be reviewed.

Penalties

The ABA supports a strong enforcement regime that provides appropriate sanctions for wrongdoing. However, we wish to raise two points around the proposed penalties outlined in the Bill:

1. The indiscriminate application of criminal offence provisions for all contraventions in the Bill is not consistent with longstanding Commonwealth policy on the framing of penalty provisions. The justification offered for this approach in the Explanatory Memorandum appears to be based on providing broad discretion for the regulator to take a 'proportional approach'. While it is appropriate that there be a range of sanctions available to respond to contraventions, the principle has always been maintained that contraventions should not attract criminal sanction unless their character justifies this approach. The *Guide to Framing Commonwealth Offences, infringement notices and enforcement powers* (the Guide) notes:

> "Ministers and agencies should consider the range of options for imposing liability under legislation and select the most appropriate penalty or sanction."

The Guide outlines the factors that should be considered in determining whether a provision should be a criminal offence (see page 13). These are consistent with the view expressed in the Australian Law

Reform Commission's Principled Regulation: Federal Civil and Administrative Penalties in Australia (ALRC Report 95):

> "the ALRC suggests that Parliament should exercise caution about extending the criminal law into regulatory areas unless the conduct being proscribed is clearly deserving of the moral censure and stigma that attaches to conduct deemed criminal…"

While it is arguable that the more serious contraventions in this package – such as failing to make a target market determination – could, due to their capacity to cause widespread harm, justify a criminal sanction, this is far less clear in relation to other provisions. For example, the addition of clause 994B(9) in the latest draft, requires that target market determinations be made available to the public free of charge. Treasury clarified, in consultation, that this requirement is to be enlivened only where a member of the public asks for the determination. It is difficult to conceive of how a contravention of this provision 'so seriously contravenes fundamental values as to be harmful to society'. The imposition of a civil penalty alone for this provision would seem to be an appropriate, and adequate sanction.

Recommendation: The Government should review the penalties slated for inclusion for consistency with the principles in the Guide to Framing Commonwealth Offences.

2. Apart from the threshold point outlined above, closer scrutiny should be given to the level at which penalties are set. For example, the offence mentioned above of failing to provide a target market determination free of charge to a person requesting it (clause 994B(9)) is subject, in the current draft, to a penalty of up to 5 years imprisonment – the second most serious tier of offence in the Corporations Act. Objectively assessed, this seems disproportionate to the level of seriousness of the contravention.

Recommendation: The proposed penalties in the draft Bill should be reviewed for consistency with the level of seriousness of offending behaviour and with other comparable provisions in the Corporations Act.

Definitions & other drafting issues

Personal advice

We acknowledge the addition of subsection 766B(3A) that seeks to clarify that the mere asking for information to determine if someone is in a target market and informing them that they are not, does not constitute personal advice. We agree with the expressed intention but make the following recommendations:

1. It should be made clear in the Bill, that the taking of reasonable steps under section 994E does not constitute personal advice under section 766B(3).
2. The use of the term 'solely' in new subsection 766(3A) should be reconsidered.

We appreciate that this is intended to limit the scope of the exemption to circumstances related to the purposes of a target market determination. However, the use of 'solely' may be so strict as to unintentionally reduce its scope. For example, in a strict sense, the subsection would not apply if questions were asked for *any* other purpose, legitimate or not. Arguably, asking for information for routine purposes could render the subsection inapplicable.

Significant detriment

For the product intervention power, we note that the concept of "significant detriment" remains undefined. In our view, it should be made clear that 'significant detriment' is not present merely because a large number of consumers have incurred an otherwise in significant detriment.

Further, it should be clarified that 'significant detriment' does not extend to immunising customers from any loss or realisation of risk where a product is operating within its risk parameters.

The term “significant dealings” (ss994F(5) and 994G) – should also be defined. There is a risk that ASIC, distributor and issuer all have different interpretations. The meaning should be beyond doubt, especially given that contravention is a criminal offence.

Review triggers

On review triggers (s994B) – it is questionable whether 10 days is practicable to cease distribution, as this would will likely require significant uplift in automation etc.

We thank Treasury for the opportunity to comment on this exposure draft and hope our comments will be of some assistance. We look forward to continuing to work with Treasury on this issue. If you have any queries regarding our submission, please contact Jerome Davidson, Policy Director, on (02) 8298 0419 or Jerome.davidson@ausbanking.org.au.

Yours sincerely

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