15 March 2017

By email to: ProductRegulation@treasury.gov.au

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

Dear Sir / Madam

Design and Distribution Obligations and Product Intervention Power – Proposals Paper

Thank you for the opportunity to comment on the *Design and Distribution Obligations and Product Intervention Power – Proposals Paper* (**Proposals Paper**). This joint submission was coordinated by Consumer Action Law Centre with funding from ASIC.

The following organisations have contributed to and endorsed this submission:

Australian Shareholders' Association
Care Inc Financial Counselling Service and the Consumer Law Centre of the ACT
CHOICE
Consumer Action Law Centre
Consumer Credit Legal Service (WA) Inc.
Consumers Federation of Australia
COTA Australia
Financial Counselling Australia
Financial Rights Legal Centre

Professor Gail Pearson (The University of Sydney Business School)

Details about each contributing organisation are contained in **Appendix A**.

Executive Summary

Consumer advocates welcome the Proposals Paper. We commend the Paper's focus on improving the existing regulatory framework to ensure consumers[1] receive fair treatment from product issuers and distributors. We believe the integrated package of reforms proposed in the Proposals Paper will significantly improve consumer outcomes in the financial system.

Contributors to this submission have supported and represented thousands of consumers dealing with financial services and credit providers over many years. We consider the introduction of design and distribution obligations and product intervention powers as some of the most significant reforms ever proposed in terms of improving outcomes for consumers. Given the number of inquiries and scandals in recent years in Australia's financial services and credit sectors, it is more important than ever that we ensure these important reforms are designed in a way that makes them flexible, future-proofed and responsive to risks of harm to consumers.

In order to achieve this, we believe the Proposals Paper needs strengthening in two important areas. Firstly, the range of products and services covered by the proposed design and distribution obligation and product intervention power should be extended, particularly in regards to credit. Exemptions from coverage, such as the proposed exemption for ordinary shares, should be restricted. Secondly, the Australian Securities and Investments Commission (**ASIC**) should be empowered to make a broader range of product interventions, particularly in relation to remuneration.

We strongly support extending the range of products covered by the design and distribution obligations and product intervention powers to regulated and unregulated credit. Contributors to this submission have extensive experience with assisting consumers who have been sold poorly designed and targeted consumer credit products, including interest-only mortgages, credit cards, payday loans and consumer leases. We have raised concerns about the proposed exempting of ordinary shares, default superannuation and real property. We have also objected to excluding wholesale clients and personal financial advice.

We broadly support the definitions of issuers and distributors, but have argued that distributors who do not receive a direct benefit from the issuers of products should also be covered by the obligations. We also support the requirement to identify target markets for products, while noting the complexities associated with this process due to the range of individual circumstances and needs of Australian consumers. A list of factors that issuers should have regard to when determining target markets, including for insurance products, has been provided.

We note that some contributors to this submission prefer the concept of an individual suitability test, rather than designing and distributing products to suitable target markets.[2] However, we acknowledge that this option is outside the scope of the Proposals Paper, so we have instead focussed our discussion on ways to ensure the proposed design and distribution obligations result in the best outcomes for consumers.

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[1] Reference to consumers throughout this paper includes reference to retail investors.

[2] For example, see Gail Pearson, The Conversation, *There are a few gaping holes in the proposals to beef up ASIC,* 16 December 2016. Available at: http://theconversation.com/there-are-a-few-gaping-holes-in-the-proposals-to-beef-up-asic-70408.

We strongly support the proposal to empower ASIC to make timely and effective product interventions when a significant risk of consumer harm is identified. We also agree that the extent of consumer detriment should not just be determined by reference to individual loss, but also where large numbers of consumers who might suffer relatively small (individual) losses. However, we oppose interventions being limited to an initial duration of up to 18 months. This is wholly insufficient, and instead interventions should continue until ASIC or the Government decides it is safe to do otherwise.

In terms of enforcement, we recommend that the full suite of ASIC enforcement tools should apply in relation to a breach of the design and distribution obligations or the requirements in an intervention: civil, criminal, injunctive and administrative. We also strongly support consumers having access to appropriate redress, including injunctions, rectification and compensation. Consumers should have access to these remedies via external dispute resolution (**EDR**) and class actions.

Table of Contents

BROAD APPROACH

Consumer advocates welcome the Proposals Paper and its draft recommendations. We commend the Paper's focus on encouraging a more consumer-centred approach to the entire product lifecycle, and ensuring that consumers receive fair and appropriate treatment from financial firms.

Until now, we have often seen a strategic and ethical failure by our financial services and credit sectors to consider: 'What do consumers need and want? How can we make it?' as opposed to 'What can we make? How can we persuade consumers to buy it?'[3]

In responding to the Proposals Paper, we have advocated for the design and distribution obligations and the product intervention power to have broad coverage across the financial services and credit sector. Exemptions would only result in regulatory gaps and encourage regulatory arbitrage by industry participants. This clearly increases the risks of consumers falling through the gaps and would limit the effectiveness of the reforms.

We have also acknowledged some of the practical difficulties associated with defining target markets effectively. Complexities will undoubtedly arise as a result of the broad range of financial products and services available in the Australian market, and the likelihood for new and innovative products to develop. Australian consumers also have a broad range of personal circumstances and needs, meaning it will not always be clear-cut whether a consumer falls within an identified target market. However, we are broadly supportive of introducing a requirement to identify target markets and distribute products accordingly, provided that ASIC gives appropriate guidance as to its expectations. We have recommended following best-practice guidance provided by the Financial Conduct Authority (**FCA**) in the United Kingdom, where similar obligations are already in place.

We have also advocated for ASIC's product intervention power to be used in a timely and pre-emptive fashion, in order to protect consumers when a significant risk of harm is apparent. Product interventions should not be used as a 'last resort', or only occur after extended consultation with industry. These delays would fundamentally undermine the purpose of the power, and would result in interventions failing to protect consumers as intended.

Breaches of the design and distribution obligations and product intervention requirements should also be dealt with effectively, using ASIC's full suite of enforcement tools. The risks of incurring penalties for breaching these obligations should not be factored in as simply a cost of doing business. They should be the cornerstone of Australia's regulatory approach. Similarly, consumers need cost effective and timely access to redress so they are able to personally hold financial services and credit providers accountable, and protect their own interests effectively. Greater consumer confidence should also bring benefits to the broader market.

[3] Similar concerns were raised by the FCA in its review of structured products: Financial Conduct Authority, *Retail Product Development and Governance – Structured Product Review,* March 2012, paragraph 5.8. Available at: https://www.fca.org.uk/publication/finalised-guidance/fg12-09.pdf.

RANGE OF PRODUCTS COVERED BY THE MEASURES

Question 1a: Do you agree with all financial products except for ordinary shares being subject to both the design and distribution obligations and the product intervention power?

All financial products, in accordance with the wider definition of financial products in the *Australian Securities and Commission Act 2001* (**ASIC Act**),[4] should be subject to both the design and distribution obligations and the product intervention power. The obligations should apply to both simple and complex financial products, as even 'simple' products have the potential to cause significant consumer harm.

Adopting the ASIC Act definition of financial products will ensure the obligations apply to some complex products that fall outside the Corporations legislation. For example, expenses only funeral insurance products are exempt from both the *Corporations Act 2001* (**Corporations Act**) and the *Insurance Contracts Act 1984* (**Insurance Contracts Act**). The notorious Aboriginal Community Benefits Fund has taken advantage of this exclusion to target Aboriginal communities, including very young people, with an expensive product that offers little benefit. Unsolicited selling appears widespread.[5] The ASIC Act also applies to a much wider set of credit products.[6]

Case study - Aboriginal Community Benefits Fund

In late 2006, a salesperson for the Aboriginal Community Benefit Fund knocked on the door of the home Elizabeth* (name changed) shared with her partner and four children aged 5, 6, 15 and 17. Elizabeth was only 39 at the time. The salesperson convinced her to sign herself, her partner and her four children up to the Aboriginal Community Funeral Plan, for a benefit amount of $6,000. Elizabeth thought it sounded like a sensible decision to set aside money for her funeral and those of her family.

What Elizabeth didn't realise was that despite appearances, Aboriginal Community Benefit Fund is not Indigenous-owned. And, she wasn't actually putting money towards her funeral and those of her family, like she thought. Elizabeth has now spent over $8,000 and asked ACBF if she could cease payments since she had exceeded the benefit amount. She was told that if she cancelled she would lose everything. Now, aged only 50 years old, she needs to keep paying fortnightly repayments (currently at $28.50) to ensure that she does not lose all the money she has already put in.

Case study provided by Consumer Action Law Centre

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[4] *Australian Securities and Investments Commission Act 2001* (Cth) s12BAA.
[5] Australian Securities and Investments Commission, *REP 453 Funeral Insurance: A snapshot,* October 2015. Available at: http://asic.gov.au/regulatory-resources/find-a-document/reports/rep-454-funeral-insurance-a-snapshot/; Kathy McLeish, ABC, *Aboriginal funeral insurance provider banned from Centrepay system following Appeal Court win,* 15 November 2016. Available at: http://www.abc.net.au/news/2016-11-15/acbf-banned-from-centrepay-system-following-centrelink-win/8027936.
[6] *Australian Securities and Investments Commission Act 2001* (Cth) s12BAA; *Australian Securities and Investments Commission Regulations 2001* (Cth) Reg 2B. This includes small business loans.

We have made further comments in relation to ordinary shares, stockbrokers, foreign issuers, foreign distributors, and real property below.

Ordinary shares

The scope of the proposed 'ordinary shares' exemption is unclear, and needs to be explored in further detail. The justifications for exempting ordinary shares given in the Proposals Paper are that these products are 'widely understood by consumers' and 'it would reduce the regulatory costs associated with capital raisings'. Presumably, the Proposals Paper is referring only to listed shares, although that is not explicit.

Many consumers would be comfortable investing in shares in the ASX100 (and perhaps the ASX200). However, outside the ASX200 the risk, transparency and governance issues become more pronounced. It should be recognised that an exemption for ordinary shares is very broad: it has the potential to expose consumers to risky low-cap shares, not just less volatile blue chip shares.

The Proposals Paper is silent as to whether share trading platforms, unlisted shares, listed unit trusts, and shares listed only on foreign markets would be covered by the proposed exemption. Exchange Traded Funds (**ETFs**), Exchange Traded Products (**ETPs**), Commodity Futures Trading (**CFTs**), Contracts-For-Difference (**CFDs**) and short-selling are also not mentioned. It is unclear whether Treasury intends for ETFs and ETPs to be subject to the exemption, since these products are exchange traded by definition but not single-entity shares. In our view, all these products should be subject to the design and distribution obligations and the product intervention power.

We recommend that the exemption (if any) be limited to fully paid ordinary shares in listed Australian companies traded on the ASX. Secondary listings (for example, for NZSE50 stocks) could be considered for exemption by ASIC on a case-by-case basis.[7]

Stockbrokers

Although the Proposals Paper suggests an exemption for ordinary shares, it is unclear whether stockbrokers will be subject to the design and distribution obligations and the product intervention power. Stockbrokers are a significant part of the distribution process in Australia's financial services industry, particularly for listed shares and trusts. Owing to the remuneration incentives in the stockbroking industry, whereby brokerage fees are charged per transaction, there is a significant risk of consumer harm. There is a strong incentive to churn stocks and recommend short-term investments to clients. A similar risk exists with stamping fees paid for Initial Public Offerings (**IPOs**). We recommend that stockbrokers be explicitly noted as subject to both the design and distribution obligations and the product intervention power.

We have provided further comments in relation to stockbroking in our response to Question 5 below.

[7] This would ensure that low-cap shares traded on alternative exchanges are not covered by the exemption.

Foreign issuers and distributors

Foreign issuers and distributors who transact with Australian consumers should also be subject to both the design and distribution obligations and the product intervention power. Although many of these financial service and credit providers are already subject to regulation as a result of transacting with Australian consumers, because the obligations are designed to apply to unlicensed and licensed providers Treasury should be explicit that foreign issuers and distributors will be covered.

Real property

Property investment advice more generally should also be within the scope of the new laws. There have been numerous inquiries that have concluded that property investment advice should be caught by the same laws as financial products.[8] Many investors have lost tens or hundreds of thousands of dollars from these complex arrangements, and ASIC has had to use circuitous routes to wind up offending companies rather than use financial services laws to protect investors and obtain compensation for them.[9]

Real property spruiking escapes financial services regulation unless it is recommended that such property be purchased via a Self-Managed Superannuation Fund (**SMSF**). This is a continuing anomaly that requires additional attention from legislators and regulators, including ASIC and the Australian Competition and Consumer Commission (**ACCC**).

We have significant concerns about property spruiking, particularly vendor finance and rent-to-buy schemes that promise the Australian dream of owning your own home—without a bank loan.[10] These deals typically do not result in achieving home ownership and in some cases financially destroy hopeful buyers. Instead, they exploit people who have a desire for home ownership but are 'locked out' of the property market.

The legal status of these schemes is extremely complex and it is often unclear which laws apply. In substance, however, they operate very similarly to complex financial products, involving intermediaries who profit from commissions and similar benefits. Vulnerable buyers, and some vendors, can suffer significant detriment yet have limited avenues for redress. We

[8] Parliamentary Joint Committee on Corporations and Financial Services, *Property Investment Advice—Safe as Houses?*, June 2005. Available at: http://www.aph.gov.au/Parliamentary_Business/Committees/Joint/Corporations_and_Financial_Services/Completed_inquiries/2004-07/investment/report/index; Parliament of Victoria Law Reform Committee, *Final Report: Inquiry into Property Investment Advisers and Marketeers*, April 2008. Available at: http://www.parliament.vic.gov.au/images/stories/committees/lawrefrom/property_investment/final_report.pdf; Senate Economics References Committee, *Scrutiny of Financial Advice Part I—Land banking: a ticking time bomb*, February 2016. Available at: http://www.aph.gov.au/Parliamentary_Business/Committees/Senate/Economics/Scrutiny_of_Financial_Advice/Report.

[9] For example ASIC's action in relation to 21st Century Group – Australian Securities and Investments Commission, *21st Century Group land banking proceedings: frequently asked questions,* October 2016. Available at: http://asic.gov.au/about-asic/media-centre/key-matters/land-banking-matters/21st-century-group-land-banking-proceedings/.

[10] Consumer Action Law Centre, *Fringe Dwellings: The vendor finance and rent-to-buy housing black market,* October 2016. Available at: http://consumeraction.org.au/fringe-dwellings-vendor-finance-rent-buy-housing-black-market-report/.

are calling for rent-to-buy arrangements to be banned, and vendor finance to be restricted to non-residential property sales.

Question 1b: Are there any financial products where the existing level of consumer protections means they should be excluded from the measures (for example, default (MySuper) or mass-customised (comprehensive income products for retirement) superannuation products)?

Exemptions to the design and distribution obligations and the product intervention power should be extremely limited. Exemptions would only create regulatory gaps and provide incentives for firms to structure their products in order to avoid the obligations. Regulatory arbitrage has already been seen with financial and credit products, such as consumer leases, as a result of exemptions to classes of products. This in turn has led to significant consumer harm (see Question 4 for further details).

We have provided further comments in relation to default (MySuper) and mass-customised superannuation products below.

Default superannuation (MySuper)

There is no compelling argument to exclude default superannuation (MySuper) from the design and distribution obligations and product intervention power provisions. We believe exclusions from the application of the obligations should be kept to a minimum. We need to ensure these obligations are future-proofed, and providing exemptions will only create incentives for poor conduct that law reform will be required to fix later. Moreover, the proposed design and distribution obligations and product intervention power will provide additional benefits to consumers beyond the current consumer protection framework for default superannuation. In particular, we believe there is an ancillary benefit to consumers if distributors have to make explicit statements about who their products are designed for.

The MySuper protections focus on setting minimum standards, which, if provided, should lead to a cost-effective superannuation offer. This includes a single, diversified investment strategy, a limit on the types of fees which can be charged and default insurance cover. Within these design protections, trustees have discretion over investment strategies and to some extent, the type and amount of default insurance offered. This discretion has to be exercised within broader obligations upon the trustee, such as the duty to act with due care and skill and the duty to act in the best interests of beneficiaries.[11]

A. Investment and longevity risk in default superannuation

In terms of product design, there are obligations on trustees to weigh members' needs in developing investment strategy.[12] Trustees can decide whether to use a 'standard balanced option' or a 'lifecycle option' for investment in MySuper products. Lifecycle options tend to alter the level of assets held in 'growth assets', gradually decreasing as you age. This is to control for 'sequencing risk' or the risk that a consumer's investments will be subject to a significant

[11] *Superannuation Industry (Supervision) Act 1993* (Cth) s52.
[12] Australian Prudential Regulation Authority, *Prudential Standard 530 Investment Governance,* July 2013. Available at: http://www.apra.gov.au/Super/PrudentialFramework/Documents/Final-SPS-530-Investment-Governance-July-2013.pdf.

market drop shortly before retirement. Many consumers experienced such a drop during the Global Financial Crisis (**GFC**). By contrast, a balanced option is a fixed investment mix that does not change with age. The difference in target market for these two products primarily comes down to managing 'longevity risk', or how long a consumer may live. For example, a trustee for a fund with members with lower life expectancy may reasonably decide it is in those members' best interests to develop a lifecycle product which decreases risk as retirement age nears. By contrast, a fund whose members have a higher life expectancy may reasonably decide it is in members' best interests to stay in a higher risk investment option until retirement as they are likely to live and perhaps work well beyond retirement age.[13]

These two investment strategies show that trustees are still able to design products for specific demographics within the default system. Depending on your expected longevity, one product may be more suitable than the other.

Design and distribution obligations would require issuers to identify appropriate target and non-target markets and select appropriately targeted distribution channels. There is a key difference between this obligation and the duty on trustees to act in the best interests of beneficiaries. The trustee duty invariably requires a balancing of beneficiaries' needs in order to develop a broadly appropriate product. Trustees are currently obliged to create products in the interests of the majority of members, which is similar to some of the proposed 'design' obligations. However, the proposed 'distribution' obligations would provide additional consumer protections by requiring trustees to not promote products to groups that would not benefit from the product. For example, we currently see some high-fee, low-risk products being promoted to younger people who are unlikely to benefit from the features of that product.

The proposed design and distribution obligations have the potential to offer an increased level of consumer protection if consumers are able to harness this information to make better purchasing decisions. For example, if the target market for a product was made available to the general public, third parties (such as consumer organisations or the media) could use this information to better understand the intended market of these products and help consumers make better decisions.

There are also issues with default superannuation options that the design and distribution obligations could address. For example, lifecycle options appear to pay greater regard to a consumer's need as the product adapts with age. However, deeper analysis conducted by Rice Warner shows that many of these products may not be living up to consumer expectations. After reviewing products available on the market the analysis showed that building more conservative (lower risk) investment portfolios at too early an age would see a reduction in member retirement benefits.[14] For example, aggressively de-risking an investment product for a 45 year old, who is potentially 20 years from retirement, is likely too early. These are not the product features of a mass designed product and would likely benefit from design and distribution obligations, so that consumers might better understand these offerings.

[13] Some contributors noted that non-SMSF funds have a very broad range of members, with different financial circumstances, ages and appetites for risk. There may be a high degree of congruence between these characteristics, but not always. These contributors noted that trustees should be able to offer a range of products. There will be a range of factors in determining a target market beyond life expectancy.
[14] Rice Warner, *Lifecycle MySuper Product Fees*, 2016. Available at: http://www.aist.asn.au/media/860083/lifecycle_mysuper_product_fees.pdf

B. Insurance in default superannuation

MySuper products must include a default level of life and Total and Permanent Disability (**TPD**) insurance on an opt-out basis. In addition, many trustees have exercised their discretion to offer Income Protection (**IP**) products on an opt-out basis. Consumers will often derive no benefit from holding multiple IP products as payouts are commonly offset by incomes from other sources, such as a second IP policy, sick leave payments, or any income (including lump sum payments) they are entitled to receive as a result of injury or illness. Given 43% of Australians have more than one superannuation account, there is a high probability that many consumers are paying for multiple IP policies, when they can only get the benefit of one. This leads to unnecessary wastage and erosion of member retirement incomes.

Given the high rates of duplicate insurance there is a high proportion of the market that would not derive any benefit from an additional income protection product. Therefore, it may be reasonable for an insurer offering default IP cover to define the market for that product as those that do not already have IP insurance. This in turn may place an obligation on a distributor to put in place reasonable controls to ensure products are distributed in accordance with the issuer's expectations. In the superannuation sector, an employer may be considered a distributor given their role in selecting default products for their workplace. Reasonable controls may include informing new employees during on-boarding of the value of duplicate IP cover or duplicate superannuation accounts in general.

This could help address a serious problem in the superannuation market that has led to the proliferation of accounts and duplicate insurance cover. Modelling from the Financial System Inquiry found that removing duplicate accounts could, on average, increase superannuation balances at retirement by around $25,000 and retirement incomes by up to $1,600 per annum.[15] About two thirds of this cost or $16,000 was due to duplicate insurance.

We have discussed the other significant features of insurance products that should be considered when determining target markets in further detail in our response to Question 10b below.

<u>Mass-customised superannuation (comprehensive income products for retirement)</u>

The rationale behind introducing comprehensive income products for retirement (**CIPRs**) is that currently individuals face 'a high decision burden at the point of retirement and receive limited guidance unless they are part of the minority who seek financial advice'.[17] The CIPRs framework would see consumers place more of the decision-making in the hands of their trustee, and trade off some of the flexibility offered in account-based pensions, in the hope of higher income. CIPRs will be designed provide a 'better anchor or reference point to help frame the retirement income decision'[18] – meaning consumers will be placing their trust in the expertise of their superannuation trustees.

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[15] Modelling prepared for the Financial System Inquiry using Treasury models, October 2014. Based on assumptions of 37 years of work with an average of 2.5 accounts over a person's working life, fixed fees of $80 per account and $140 for insurance per account per annum (in 2014 dollars).

[17] The Treasury, *Development of the framework for Comprehensive Income Products for Retirement,* December 2016. Available at: https://consult.treasury.gov.au/retirement-income-policy-division/comprehensive-income-products-for-retirement/..

[18] Ibid.

The proposal for CIPRs is to introduce product design so that:

> *Trustees could choose to design a single mass-customised CIPR that would be in the best interests of, and offered to, the majority of their members. However, trustees would not be required to design and/or offer a product that is in the best interests of any particular member.*[19]

As already discussed in relation to accumulation phase superannuation products, the goal of mass customisation is to suit the interests of the majority of members. However, this may not be appropriate for members who do not share the same characteristics as other members of a fund. For these consumers, the design and distribution obligations will be a useful information source to help decide if staying in the fund will best meet their individual needs.

Even more so than accumulation phase superannuation products, CIPR product design will be heavily influenced by life expectancy. It does raise the issue about how much consumers know about their life expectancy, which is a subject worthy of further exploration. However, consumers that know about their risk factors through family history, pre-existing conditions, etc. may be in a position to select a default product, which meets minimum standards, but is better tailored to their individual needs. For example, a consumer with low risk factors (for example, a white collar worker with no pre-existing medical conditions or family history of medical issues) may select a product with a greater investment in annuities. Such a product is likely to be a better match for the longevity risk the consumer is attempting to mitigate.

It is proposed that CIPRs will be subject to some minimum standards, that if trustees comply with they will be offered a 'safe harbour' from claims. These minimum standards are yet to be settled upon. The Treasury's recent CIPR Discussion Paper points to trustee self-assessment with regulator oversight to ensure products are designed to be mass-customised and suitable for the majority of members.[20] However, the proposed system would make consumer scrutiny of product design difficult. Design and distribution obligations have the potential to make the target markets of products much more transparent and could help guide consumers to make better purchasing decisions.

Overall, we do not consider these standards sufficient to supplant the need for the design and distribution obligations and product intervention power to apply to CIPRs. In particular, we see the requirement under the design and distribution obligations to select target markets as being complementary to the proposed CIPR requirements, as opposed to being a case of regulatory duplication.

Given the benefits described above, we do not support the exclusion of CIPRs from the broad scope of design and distribution obligations and product intervention power provisions. We expect ASIC would use these powers judiciously in general and rarely need to exercise them in regard to CIPRs. Nonetheless, keeping CIPRs within that broader consumer protection framework allows for appropriate action by ASIC should it view it necessary. Carving some financial products out of the design and distribution obligations and product intervention power framework adds unnecessary complexity and may create problems in the future.

[19] Ibid.
[20] Ibid.

Question 2: Do you agree with the design and distribution obligations and the product intervention power only applying to products made available to retail clients? If no, please explain why with relevant examples.

The design and distribution obligations and the product intervention powers should apply to products made available to retail and wholesale clients. This is in line with the approach of the FCA, where financial firms have similar obligations and powers. The FCA has said 'that poor conduct in wholesale markets can harm the wider market by passing on risk and detriment to retail consumers.'[21]

If Australia truly wants to shift towards a consumer-centric financial services industry, we need a 'root and branch' approach to reform that recognises that wholesale markets have a profound impact on our retail markets. Effective, efficient and stable wholesale markets should be a 'jewel in the crown' of our financial services industry, rather than a mere afterthought.[22] As noted by the FCA, '[p]oor wholesale conduct is not a victimless act simply because it takes place in between sophisticated market participants...It also captures a range of activities that exploit differences in knowledge or market power to undermine trust in the integrity of markets or cause harm to retail consumers".[23]

An example of wholesale conduct with the risk of harm to retail clients is set out below:

Example – Wholesale FX[24]

In December 2016, ASIC has accepted enforceable undertakings from the National Australia Bank Limited (NAB) and the Commonwealth Bank of Australia (CBA) in relation to the banks' wholesale spot foreign exchange (FX) businesses.

As a result of ASIC's investigation, ASIC was concerned that between 1 January 2008 and 30 June 2013, both banks failed to ensure that their systems and controls were adequate to address poor conduct by staff including:

- attempts to manipulate the market for a currency, including by placing offers without a legitimate commercial reason and attempts to influence benchmark rates;
- inappropriate trading while in possession of confidential and potentially material information; and

[21] Financial Conduct Authority, *FCA Enforcement and the Wholesale Markets,* November 2014. Available at: https://www.fca.org.uk/news/speeches/fca-enforcement-and-wholesale-markets.
https://www.fca.org.uk/news/speeches/fca-enforcement-and-wholesale-markets.
[22] Ibid.
[23] Prof. Dimity Kingsford Smith and Dr Marina Nehme, *Product Intervention Powers: a Legal, Comparative & Policy Analysis,* 2016, p. 15. Available at: http://download.asic.gov.au/media/3251548/product-intervention-powers-a-legal-comparative-and-policy-analysis.pdf - quoting Financial Conduct Authority, October 2012, p. 12. Available at: https://www.fca.org.uk/publication/corporate/fsa-journey-to-the-fca.pdf.
[24] Australian Securities and Investments Commission, *16-455MR ASIC accepts enforceable undertaking from NAB and CBA to address inadequacies within their wholesale spot FX businesses,* 21 December 2016. Available at: http://asic.gov.au/about-asic/media-centre/find-a-media-release/2016-releases/16-455mr-asic-accepts-enforceable-undertaking-from-nab-and-cba-to-address-inadequacies-within-their-wholesale-spot-fx-businesses/.

- disclosures of client confidential information.

ASIC was concerned that this behaviour had the potential to undermine confidence in the proper functioning of Australia's FX market, which has a significant number of retail participants.

It is also important to note that 'wholesale clients' are not just banks and big business. Mum-and-dad investors can also be considered wholesale clients if they meet one of the relatively simple tests in the Corporations Act. For example, under the 'sophisticated investor' test[25] a financial services licensee can treat an investor as a wholesale client if they:

- are satisfied that the client has previous experience in using financial services and investing in financial products that allows them to assess the risks and merits of the product;
- give the client before, or at the time when, the product or advice is provided a written statement of the licensee's reasons for being satisfied as to those matters; and
- obtain a written acknowledgement from the client.

Retail investors can also be treated as wholesale clients if they simply provide a copy of a certificate given by a qualified accountant that states that the person:

- has net assets of at least $2.5 million; or
- has a gross income for each of the last 2 financial years of at least $250 000.[26]

It is not difficult to imagine unscrupulous financial service providers taking advantage of these provisions in order to avoid the application of the product intervention power or the design and distribution obligations.

Question 3: Do you agree that regulated credit products should be subject to the product intervention power but not the design and distribution obligations? If not, please explain why with relevant examples.

We strongly support both regulated and unregulated credit being subject to the product intervention power and the design and distribution obligations. The Proposals Paper justifies the proposed exemptions for credit products on the basis that there is a 'potential overlap with the responsible lending obligations that already apply to credit products'. However, responsible lending obligations offer different (and lesser) protections to consumers than the proposed product intervention power and design and distribution obligations.

Refer to Question 4 for our comments in relation to unregulated credit, which is not subject to responsible lending obligations.

[25] *Corporations Act 2001* (Cth) s761GA.
[26] *Corporations Act 2001* (Cth) s761G; *Corporations Regulations 2001* (Cth) Reg 7.1.28.

Responsible lending obligations vs design and distribution obligations

Under the *National Consumer Credit Protection Act 2009* (Cth) (**the National Credit Act**), credit providers ('issuers') and credit assistance providers ('distributors') have responsible lending obligations which require an assessment that the credit contract or consumer lease is 'not unsuitable' for the consumer. As explained in ASIC's Regulatory Guide 209,[27] a credit contract or consumer lease will be, and must be assessed as, unsuitable where, at the time of the assessment, it is likely that:

- the contract does not meet the consumer's requirements and objectives; or
- the consumer will be unable to meet their payment obligations, either at all or only with substantial hardship.

In undertaking the assessment, providers must make reasonable inquiries about the consumer's requirements and objectives and their financial situation, and take reasonable steps to verify this information.

The current responsible lending obligations apply only at the point of sale. For credit providers, the obligations apply when the provider enters into a credit contract with a consumer or increases the consumer's credit limit. For credit assistance providers (such as mortgage brokers), the obligation to undertake the assessment applies when it is suggested that the consumer apply for a particular credit product.[28]

In contrast, the design and distribution obligations would apply during product design, during the entire product distribution process and after the sale of a product.[29] These obligations offer different, and far broader, protections than the current responsible lending obligations. The current 'not unsuitable' standard for credit products is essentially a weakened version of an individual suitability test at the point of sale, as opposed to an obligation to design safe and suitable credit products and distribute them to appropriate target markets. We have provided examples of credit products being targeted at unsuitable groups of consumers below.

The design and distribution obligations also require issuers to agree with distributors on how a product should be distributed, and distributors to have controls in place to act in accordance with the issuer's expectations. It also requires issuers to regularly review their arrangements with distributors. Under the current National Credit Act, a credit provider is not required to supervise distributors of its products, unless the distributor is acting as an authorised credit representative under the credit provider's Australian Credit Licence. Most credit assistance providers operate under their own (or a different) Australian Credit Licence, meaning credit providers generally have limited (if any) statutory obligations to supervise the distribution of their products.

[27] Australian Securities and Investments Commission, *Regulatory Guide 209 Credit licensing: Responsible lending conduct,* November 2014, paragraph 209.3. Available at: http://download.asic.gov.au/media/2243019/rg209-published-5-november-2014.pdf.
[28] Or remain within a credit contract or increase a credit limit.
[29] The Treasury, *Design and Distribution Obligations and Product Intervention Power*, 13 December 2016, p. 49. Available at: http://www.treasury.gov.au/ConsultationsandReviews/Consultations/2016/Design-and-distribution-obligations-and-product-intervention-power.

Credit products targeted at unsuitable groups

Below we have set out a number of examples of credit products that are unsuitable for certain classes of consumers, yet are unlikely to breach the 'not unsuitable' test under Australia's current responsible lending laws:

- **Interest-only loans:** Interest-only loans are generally only suitable for investors who might be deducting interest payments for tax purposes and are using the savings from lower repayments to pay down other debt, or pay for something productive. However, ASIC has reported that many interest-only mortgages are being sold to owner-occupiers rather than investors, and seem to be targeted towards a wider group that they are likely to benefit.[31] Responsible lending obligations do not prohibit this, because a lower repayment amounts at the point of sale might appear affordable and 'not unsuitable', despite the fact the consumer is not paying down the principal.

- **Line of credit loans**: Line of credit loans allow a person to take out a loan against a proportion of the equity they have in their home. In our view, line of credit loans are probably only suitable for investors (for similar reasons as interest-only loans), or for people that are very disciplined with their spending. Line of credit loans are not suitable for people with poor impulse control, or owner-occupiers who may place their home at risk if they fall behind in repayments. Responsible lending would not address this, as the loan would still generally be considered 'not unsuitable' if repayments were affordable.

- **Credit cards**: Different credit cards are clearly more suitable for some groups of consumers than others. For example, cards that offer frequent flyer points or other rewards would generally be unsuitable for consumers who are unable to repay their account balance in full each month, as the interest charges would outweigh the value of any reward points. Balance transfer cards that offer zero-interest for 12 months are also unlikely to be suitable for consumers who are unable to repay their balance within 12 months and will continue to use the card for new purchases, as they could be stung with higher interest than they previously had. The current responsible lending obligations have not precluded these products from being sold to these groups.

Designing harmful products: Payday loans and consumer leases

Currently, there is no overall obligation that prevents credit providers from designing inherently harmful, high-cost credit products. Two high-cost credit products that we have been concerned about for many years are payday loans and consumer leases.

Payday loans are loans of up to $2,000 for a period of less than 12 months. Payday lenders are permitted to charge an upfront 'establishment fee' of 20% of the amount borrowed, plus a monthly fee of 4% of the amount borrowed. Annualised percentage rates for payday loans

[31] Australian Securities and Investments Commission, *REP 445 Review of interest-only home loans,* 20 August 2015. Available at: http://asic.gov.au/regulatory-resources/find-a-document/reports/rep-445-review-of-interest-only-home-loans/.

generally range between 407% and 112.1%.[32] Payday loans are usually taken out to cover day-to-day living expenses rather than genuine one-off cash emergencies. Repayments are generally direct debited on the day wages or welfare payments are received, meaning people can easily be caught in a harmful cycle of repeat borrowing. The 'presumptions' of unsuitability have failed to break this cycle. If the design and distribution obligations applied to payday loans, these loans would be required to be designed and distributed as 'one-off' short-term fixes for debt problems. Currently, they are designed to lead to a dangerous debt spiral.

Consumer leases are a type of 'rent to buy' arrangement, but the catch is that despite paying huge amounts for basic goods and vehicles, the lessee actually has no contractual right to own the goods. There is no cap on the fees charged by consumer lease providers, unlike payday lenders and other credit providers. Lease providers are also not required to advertise the total rental amount or retail price (or an effective interest rate). Consumer leases generally cost at least twice the retail price, usually three times and sometimes more. The cost of a consumer lease is usually advertised as a low 'per week' amount, but lease providers do not disclose the total rental amount or retail price in advertisements. These products are targeted at people who cannot afford the upfront cost of basic household goods and vehicles. If the design and distribution obligations applied to consumer leases, they would be required to be designed fairly and targeted at consumers who could afford and understand the credit contracts they were entering into.

Payday lenders and consumer lease providers targeting vulnerable groups

We have seen numerous examples of harmful credit products being targeted at vulnerable groups in our community, particularly payday loans and consumer leases. These products are designed to exploit those without access to mainstream finance, and who are in desperate need of cash, household goods or vehicles.

We have seen multiple examples of inappropriate credit products being targeted at vulnerable groups, including:

- Residents across housing estates;
- Women from disadvantaged low income households;
- Women escaping domestic violence;
- Participants engaged in drug and alcohol treatment programs; and
- People with gambling addictions.

For example, high cost consumer lease provider Motor Finance Wizard targets low income groups including bankrupts, self-employed consumers, and consumers with poor credit histories. Even a cursory glance at their online advertising indicates that their target audience is inappropriate for the high cost leases they are peddling.[33]

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[32] Comparison rate calculations completed using RiCalc software assuming maximum permitted fees and charges, and fortnightly repayments. 407.6% comparison rate calculated using a 30-day loan of $200 with total repayments of $248. 112.1% comparison rate calculated using a 12-month loan of $1,000 with total repayments of $1,680.

[33] https://www.youtube.com/watch?v=nD9wXRvmReU; https://www.youtube.com/watch?v=9yWf_tulqO4; https://www.youtube.com/watch?v=up6Bwq_IoWo

Further evidence of the inappropriate target markets of these products was provided by ASIC's report on consumer leases for household goods. ASIC's report found that people receiving Centrelink payments are being charged much higher prices than the prices advertised by consumer lease providers. For two year leases, half the Centrelink recipients in ASIC's study paid more than five times the retail price of the goods. ASIC said that there is a high use of consumer leases by financially vulnerable consumers, and that it continues to be concerned about low standards of conduct by some lessors, despite multiple enforcement actions undertaken by ASIC.[34] In essence, those who can least afford to pay are being targeted by credit providers offering the highest cost finance.

Further examples of high cost finance being targeted at our most vulnerable groups are set out below.

Case study – Consumer leases

Susan* (name changed) visited Motor Vehicle Finance Provider in 2014 and signed up for a 5-year car lease agreement worth $33,000. The market value of the car today is approximately $5,000. Susan is a single parent with 2 children whose sole income is from Centrelink. Susan could not afford the repayments of $250 per fortnight. After making the car lease repayments, Susan had only $4873 per fortnight left to pay for her other expenses. Susan said that she thought she would own the car outright at the end of the lease, but under the contract she had no right to own the car.

FRLC made a complaint on behalf of Susan to the motor vehicle finance provider, who confirmed that they had miscalculated Susan's living expenses and refunded her repayments. The car was returned to Susan, who was released from liability and refunded all of her repayments.

Case study provided by Financial Rights Legal Centre

Case study – Payday loans

Richard* (name changed) is 41 years old. His gambling problem began with a visit to the casino when he turned 18. Richard is now addicted to playing poker machines. When he has blown his money, he sometimes needs money for rent and other expenses so takes out payday loans. Richard says he always has at least two payday loans on the go, and couldn't count how many he has in a typical year. Richard says his payday lender knows him by name, and knows about his gambling addiction.

Richard pays the loans back within 4 to 6 weeks, but just before his current loan is paid off the lender will SMS him to offer him a new loan. When Consumer Action spoke to Richard

[34] Australian Securities and Investments Commission, *REP 447 Cost of consumer leases for household goods,* 11 September 2015. Available at: http://asic.gov.au/regulatory-resources/find-a-document/reports/rep-447-cost-of-consumer-leases-for-household-goods/.

he was in default as he needed to pay for his car registration fees and couldn't afford his repayments. He says it is difficult to contact the lender to ask for hardship arrangements.

Case study provided by Consumer Action Law Centre[35]

Example – ASIC enforcement action against Ray Rentals[36]

An ASIC investigation found that Ray Rentals was providing regulated credit without a credit licence and was promoting this activity on its website. Ray Rentals was found to be largely targeting consumers living in remote Indigenous communities. ASIC banned this unlicensed Victorian-based lessor and its sole director from offering credit for four years.

Example – ASIC enforcement action against Zaam Rentals[37]

ASIC banned the director and former director of Zaam Rentals from engaging in credit activities for six years and four years, respectively. ASIC also cancelled Zaam Rentals' credit licence for failing to comply with the responsible lending obligations. Zaam Rentals was found to be targeting vulnerable consumers in remote Indigenous communities in Mildura, Victoria, and surrounding areas in New South Wales.

ASIC subsequently also excluded the directors of Zaam Rentals' franchisees from the industry by requiring them to enter into written undertakings with ASIC stating they will not engage in credit activities for three-and-a -half years. This misconduct was identified by Mallee-Murray Community Legal Centre with support from Consumer Action Law Centre.

There is no question that high cost payday loans and consumer leases are not suitable for these groups. In general, they have little to no discretionary income and are at significant risk of falling into a debt spiral. The marketing of these products is often confusing (and potentially misleading). For example, most consumer lease advertisements highlight the amount payable per week, rather than the total amount owed and the recommended retail price. Many of our clients, who are targeted by these products, have limited literacy skills. These advertisements are designed to appear as though the clients are getting a bargain, but in fact they are being charged an exorbitant amount.

[35] Originally published in Consumer Action Law Centre, *Review of the small amount credit contract laws – submission,* 16 October 2016. Available at: http://consumeraction.org.au/review-of-the-small-amount-credit-contract-laws-submission/.

[36] Australian Securities and Investments Commission, *REP 447 Cost of consumer leases for household goods,* 11 September 2015, p. 33. Available at: http://asic.gov.au/regulatory-resources/find-a-document/reports/rep-447-cost-of-consumer-leases-for-household-goods/.

[37] Ibid.

As noted above, the current responsible lending obligations apply only at the point of sale, and do not require credit product issuers or distributors to design and target their products appropriately. One of the challenges for a regulator in enforcing the responsible lending laws with respect to products targeted at very vulnerable groups is that the misconduct is rarely reported to the regulator. Vulnerable people often do not want to be involved in regulator action as there are a range of life circumstances that can act as a barrier.

There are also evidentiary issues in proving misconduct in individual cases (as opposed to proving credits are unsuitable for particularly classes of consumers), as regulators sometimes need to rely on verbal representations that are often not properly documented. This issue was raised in a recent Senate Estimates Committee hearing about ASIC's investigation into payday lending giant Cash Converters. When questioned as to why only online borrowers would be entitled to automatic compensations for irresponsible lending by Cash Converters, rather than in-store borrowers, ASIC chairman Greg Medcraft told the hearing it would have been more difficult to investigate the in-store loans:

> *"With online (loans) we had all the evidence online, exchanges between the borrower and the lender," Mr Medcraft said.*
>
> *"Whereas if you had have gone in store, basically the communication would have been verbal, it may not have been documented in the same way."*[38]

This is yet another reason why the responsible lending obligations have had limited success in protecting vulnerable groups from being targeted by these harmful credit products.

Question 4: Do you consider the product intervention power should be broader than regulated credit products? For example, 'credit facilities' covered by the unconscionable conduct provisions in the ASIC Act. If so, please explain why with relevant examples.

We strongly recommend that the product intervention power and the design and distribution obligations be extended to unregulated credit. We have particular concerns about unregulated consumer leases and pawn broking being exempt from these obligations.

Pawn broking

Despite there being an inextricable link between payday lending and pawn broking, pawnbrokers are expressly excluded from the operation of most of the national credit laws under the National Credit Act.[39] Instead, pawn brokers are regulated by state and territory legislation. As a result, pawn brokers are not subject to the requirements around responsible lending, limits on fees and charges of small loans, and the requirement on providers to be members of external dispute resolution scheme.

We regularly receive complaints from consumers who have pawned goods to pay for basic necessities, or to fund drug and gambling addictions. The pawned goods often hold relatively

[38] Amy Bainbridge, *Cash Converters loans: Corporate watchdog grilled over investigation into payday lender,* 2 March 2017. Available at: http://www.abc.net.au/news/2017-03-02/corporate-watchdog-defends-investigation-into-cash-converters/8318342.

[39] *National Consumer Credit Protection Act 2009* (Cth) s6(9).

little monetary value, but significant sentimental value. When unable to make repayments, desperate consumers can be encouraged to extend their pawn broking agreement by paying monthly interest payments. This means that the most disadvantaged Australians can end up paying significant amounts of interest to avoid having their goods sold, and become stuck in a dangerous debt spiral.

Pawn broking is subject to the unjust transaction provisions of the National Credit Code. However, this protection is largely illusory for the vulnerable consumers targeted by these businesses because there is no accessible forum where a consumer can make a complaint. Pawnbrokers are not required to be members of an external dispute resolution scheme.

A number of payday lenders have shopfronts that offer both pawn broking and payday lending services that clearly target disadvantaged Australians. In the case below, one consumer told us he was provided with a payday loan to repay a pawn broking loan at another counter within the same store.

Case study – payday loans and pawn broking[40]

James says he has had approximately 8 to 12 payday loans from a payday lender (that also operates as a pawnbroker) in the last 12 to 18 months, but he's lost count. James says that he was recently provided a loan from one counter, which he then used to pay off his pawn broking loan at another counter of the same store. The payday lender listed his monthly expenses (excluding rent) as less than $550 per month, based on a default calculation of expenses that equals just 15% of borrowers' income. James says that his monthly expenses are much higher. James says that he generally used the loans for groceries and living expenses, such as rent.

James says that he had trouble paying back the loans, and that he got caught in a cycle where he had cash flow problems. The default fees were significant so when he defaulted on one contract about 3-4 times, he was left with little money to make ends meet.

Case study provided by Consumer Action Law Centre

Case study – Cash Converters taken to court[41]

On 1 March 2017, a Victorian mother of seven took Cash Converters to court alleging that 76 pawn agreements and 23 payday loans were unjust and unconscionable. She alleges that repaying the payday loans and pawn agreements caused her substantial hardship.

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[40] Originally published in Consumer Action law Centre, *Review of Small Amount Credit Contract laws – submission*, October 2015. Available at: http://consumeraction.org.au/review-of-the-small-amount-credit-contract-laws-submission/.

[41] For more information, see Christopher Knaus, *Cash Converters facing legal action over 100 high-interest loans to one woman,* 1 March 2017. Available at: https://www.theguardian.com/australia-news/2017/mar/01/cash-converters-facing-legal-action-over-100-high-interest-loans-to-one-woman.

"This Victorian mother alleges that because of these loans and pawn agreements she was left without enough money to pay for her family's everyday expenses,' said Lachlan Edwards, Solicitor at Consumer Action Law Centre.

The claim, lodged in the Magistrates Court, also alleges that the pawn agreements carried an effective interest rate of between 360% per annum and 420% per annum.

'In Victoria under a pawn agreement a lender can charge whatever fees they like,' Edwards said.

Consumer Action is concerned that payday lenders will increasingly give people pawn agreements because they are less regulated. For example, responsible lending laws do not apply to these types of agreements.

Case study provided by Consumer Action Law Centre

Unregulated short-term and indefinite consumer leases

Section 171 of the National Credit Code exempts short term leases (those for four months or less) and indefinite leases from regulation altogether. This encourages lease providers to artificially structure their agreements to fall under these exemptions, leaving their customers without protection under the Code.

These exemptions allow avoidance from regulation without creating any discernible benefit. Consumer Action has been unable to establish why these exemptions from credit regulation (which pre-date the current National Credit Code) were created, and it makes no sense to extend yet another exemption to these businesses under the proposed design and distribution obligations and product intervention power.

Continuing credit contracts

We are also concerned that continuing credit contracts, such as those offered by Certegy Ezi-Pay, would be exempt from the operation of the proposed design and distribution obligations and product intervention power. These credit providers claim to offer zero-interest financing for goods in order to avoid regulation under the National Credit Act. This model simply hides the cost of finance as merchants are charged extra fees for providing this credit 'service' to their customers.[42] This means that consumers signed up to these arrangements are being charged additional fees but are not protected by responsible lending obligations or access to external dispute resolution.

Increasingly, we are seeing products such as solar panels being sold via door-to-door sales using this form of credit. While these companies purport not to charge interest, we suspect

[42] For example, see Joyce Moullakis, *Former Macquarie manager Katherine McConnel looks to shake up energy finance,* 10 October 2016. Available at: http://www.afr.com/business/banking-and-finance/former-macquarie-manager-katherine-mcconnell-looks-to-shake-up-energy-finance-20161007-grxl2x; Financial and Consumer Rights Council, *Afterpay: what you need to know,* 8 February 2017. Available at: http://www.fcrc.org.au/member-news/afterpay-what-you-need-to-know.

that interest is built into the retail price of the goods, meaning the value of the goods being purchased is often significantly less than the amount being borrowed.

Many of the consumers targeted by door-to-door salesmen peddling these financed goods are elderly or low income, and for whom the products are clearly unsuitable.

Case study – continuing credit contract and solar panels

Bill* (name changed) is over 70 years old and his only source of income is from Centrelink. In 2013, he purchased and paid for solar panels to cover the roof of his home, which cost approximately $5,000 (after the solar panel rebate).

In mid-2016, a door-to-door salesman came to Bill's home. Bill told the salesman he already had solar panels but the salesman persisted. Two days later, the salesman returned with an agreement and information on how Bill could fund the purchase.

The salesman told Bill there was sufficient space on the roof of his shed to install more panels, and that the savings he would make on his electricity bill would cover the cost of the solar panels ($8,500). Bill was also told that he could access an 'interest free loan' to pay for the solar panels. However, after 3 months Bill had only saved $30 on his electricity bills and he could not afford the fortnightly repayments for the new solar panels.

Financial Rights Legal Centre (**FRLC**) contacted the continuing credit contract provider alleging that, among other things, the value of the solar panels was around $5,000 (based on quotes and invoices obtained for similar solar panel systems). FRLC alleged that this meant a charge had been made for the credit and the Continuing Credit Contract Provider could not rely on the exemption from regulation in the National Credit Act. The continuing credit contract provider agreed they breached consumer law by failing to outline Bill's cooling off rights but denied they are regulated by the National Credit Act and refused to comment on the allegations made.

The continuing credit contract provider released Bill from the contract, refunded the amounts he had paid to date and allowed our client to retain the solar panels.

Case study provided by Financial Rights Legal Centre

DESIGN AND DISTRIBUTION OBLIGATIONS

Question 5: Do you agree with defining issuers as the entity that is responsible for the obligations owed under the terms of the facility that is the product? If not, please explain why with relevant examples. Are there any entities that you consider should be excluded from the definition of issuer?

We agree with defining issuers as the entity that is responsible for the obligations owed under the terms of facility that is the product, in line with the definition of issuers in the Corporations

Act.[43] In relation to credit, we recommend that the definition of issuers reflect the definition of 'credit providers' in the National Credit Code.[44]

As noted above, we strongly discourage any exclusions as they would have the potential to create regulatory gaps and will encourage regulatory arbitrage. We agree with the intention outlined in the Proposals Paper, which is 'to cover the market as comprehensively as possible to avoid any possible gaps in the market'.[45]

Question 6: Do you agree with defining distributors as an entity that arranges for the issue of a product or that:

> ***(i)*** ***Advertise a product, publish a statement that is reasonably likely to induce people as retail clients to acquire the product or make available a product disclosure document for a product; and***
>
> ***(ii)*** ***Receive a benefit from the issuer of the product for engaging in the conduct referred to in (i) or for the issue of the product arising from that conduct (if the entity is not the issuer).***

We agree that, when determining who is an issuer or distributor, it is preferable to use existing concepts already contained within the Corporations Act to ensure consistency of application. On this basis, we recommend that the proposed first limb of the definition of 'distributor' above ('an entity that arranges for the issue of a product') should be extended to include all kinds of 'arranging to deal', not just arranging to issue a product.

By extending the definition of 'distributor' to all kinds of arranging to deal, coverage would extend to all financial service providers that arrange for another person to:

- apply for or acquire a financial product;
- issue a financial product;
- in relation to securities or managed investment interests - underwrite the securities or interests;
- vary a financial product; or
- dispose of a financial product.[46]

This not only ensures consistency with the Corporations Act and financial services licensing regimes, but also reduces the potential for regulatory gaps. We have provided further comments in relation to the second limb of the proposed definition below.

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[43] *Corporations Act 2001* (Cth) s761E.
[44] A credit provider is defined as 'a person that provides credit, and includes a prospective credit provider': National Credit Code s204.
[45] The Treasury, *Design and Distribution Obligations and Product Intervention Power*, 13 December 2016, p. 13. Available at: http://www.treasury.gov.au/ConsultationsandReviews/Consultations/2016/Design-and-distribution-obligations-and-product-intervention-power.
[46] *Corporations Act 2001* (Cth) s766C.

Question 7: Are there any situations where an entity (other than the issuer) should be included in the definition of distributor if it engages in the conduct in limb (i) but does not receive a benefit from the issuer?

The design and distribution obligations should not be limited to distributors that receive a benefit from the issuer of the product. While benefits received from issuers have the potential to cause significant consumer harm, as evidenced in the ASIC report on life insurance advice and its upcoming report on mortgage broking remuneration,[47] there are also risks to consumers posed by fee-for-service and other remuneration models.

There are myriad potential income streams for distributors, other than direct benefits from issuers. Simply because a distributor is obtaining its revenue from elsewhere does not necessarily mean that consumers will be protected from loss, and therefore that the design and distribution obligations need not apply. A consumer who pays a direct benefit to a distributor should not be offered lesser protections than a consumer who acquires a product from a distributor that receives a direct benefit from an issuer.

Examples of some alternative revenue streams are outlined below.

Stockbroking

Stockbrokers generally charge brokerage fees, which are paid by clients rather than the issuers of the financial products. The potential for this remuneration structure to encourage churning and other undesirable behaviour is well established.

Example – Bell Potter churning claims

In December 2016, ABC reported that stockbroking giant Bell Potter was facing claims it cheated a dying man and his wife out of $1 million while he was succumbing to Alzheimer's disease. The man's family accused his former Bell Potter financial advisor of carrying out hundreds of unauthorised share trades in his self-managed superannuation fund.[48]

The family claimed Bell Potter charged brokerage commissions on the trades totalling $133,516. The family's lawyer said that "The advisor's activity here appears to be a case of share churning… Churning is where an advisor transfers a client from one financial product to another for the purpose of generating commissions and fees, and that's typically done in circumstances where the transfer is not in the best interest of the client."

Bell Potter refunded the brokerage after the family complained. We are unaware of the outcome of the litigation.

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[47] Australian Securities and Investments Commission, *REP 413 Review of retail life insurance advice,* 9 October 2014. Available at: http://asic.gov.au/regulatory-resources/find-a-document/reports/rep-413-review-of-retail-life-insurance-advice/; George Lekakis, *Mortgage brokers face crackdown on commissions,* 30 October 2016. Available at: http://thenewdaily.com.au/money/finance-news/2016/10/30/mortgage-broker-crackdown/.

[48] Pat McGrath, *Stockbroker Bell Potter accused of cheating man with Alzheimer's out of $1 million,* 15 December 2016. Available at: http://www.abc.net.au/news/2016-12-15/stockbroker-accused-of-cheating-man-with-alzheimers-out-of-$1m/8123296.

Asset-based fees

The Future of Financial Advice (**FoFA**) reforms banned some but not all conflicted remuneration for financial advice. Asset-based fees, which are ongoing fees calculated as a percentage of the total funds under advice, are still permitted and are the main way consumers currently pay for advice. Asset-based fees encourage advisers to direct clients into certain types of investments over others, such as managed investment schemes over real estate. They are significantly less transparent than fixed fees for advice and encourage business models in which a client continues to pay a fee long after they have received advice.

Other income streams

In our increasingly innovative financial services landscape, there is no doubt that new revenue streams will be identified. Two simple examples include online advertising revenue and subscription fees, which often go hand in hand with other revenue streams. See below for an example.

Case study – Subscription and brokerage fees

Melbourne SMSF Group recently encountered a financial services provider which claims to offer very low share brokerage fees, plus stock market research data for investors and share portfolio management tools.

A main feature of this business model is to provide details of the share portfolios of other clients, highlighting the most successful. This establishes a competitive environment where clients are encouraged to switch their investments to match those of the most successful portfolios. The software provides recommendations on which shares to sell and which to buy. This often requires perhaps 30 or so buy/sell transactions. Of course, a few weeks later someone else is in front, and so more transactions are required to keep chasing the apparent "best portfolio".

This approach relies on random and often illogical short term fluctuations in stock prices as a basis for making important investment choices. This process of stock selection is totally lacking in sound investment principles and could only be regarded as resorting to pure chance. In other words, investors are being enticed into a form of competitive gambling. Perhaps to less experienced investors, this approach to stock selection may appear to make sense.

The company providing this facility makes money from an up-front subscription fee plus brokerage fees for each transaction. The financial services provider has recently been targeting SMSFs and so significant retirement savings are likely to be involved.

The financial services provider has been operating for about 4 years and claims to have about 3,000 clients on their books.

The financial services provider claims to have been praised by ASIC for a feature in their software designed to protect clients from the risk of low levels of diversification. In reality, the system simply encourages clients to hold a larger number of stocks – all of which could be very risky investments. Presumably more stocks held translates to a greater number of trades, and higher brokerage charges.

Case study provided by Melbourne SMSF Group

Question 8: Do you agree with excluding personal financial product advisers from the obligations placed on distributors? If not, please explain why with relevant examples. Are there any other entities that you consider should be excluded from the definition of distributor?

We oppose providing a general exclusion for personal financial product advisers from the obligations placed on distributors. Personal financial product advisers play an important role in the distribution chain, and we reiterate our concerns that providing numerous or wide exclusions has the potential to create regulatory gaps and will encourage regulatory arbitrage. We want to avoid creating gaps in the regulatory framework which will leave consumers vulnerable to certain products and poor practices. Providing broad exemptions also has the potential for creating a competitive distortion between personal and general advice providers.

We see the application of the distributor obligations to financial product advisors as complementary to the existing best interests duty, rather than a case of regulatory duplication. If the distribution obligations applied, advisors would be expected to put in place appropriate controls to ensure products are distributed in accordance with the issuer's expectations and to comply with reasonable requests for information from the issuer, which they are not currently required to do. This would assist advisors to discharge their duty to act in the client's best interests, but also improve the supervisory powers of issuers and ultimately lead to better consumer outcomes.

An example of poor personal financial product advice is set out below.

Case study – Advice to set up an SMSF

A young woman came to the Melbourne SMSF Group wishing to learn more about the SMSF she had started on the advice of a company which had sold her their share trading software. She was 25 years of age, on a very modest income and had savings of about $10,000. She was quite intelligent but had no real financial knowledge or experience.

The company which advised her to start a SMSF directed her to an accountant who set up her fund. The share trading software company and the accountant both knew that she was starting her fund with a very small amount of money. The accountant had charged her about $1,500 in accounting and audit fees for each of the two years the fund had existed (total of $3,000).

The Australian Taxation Office was pursuing her for the fund tax return for the first year of operation – which had not been lodged. The accountant claimed to have filed the return for her but could not provide a copy, resulting in a dispute between her and the accountant.

The share trading software she had been sold was based on techniques that amounted to little more than gambling. the savings that she had placed in her SMSF were being quickly eroded – and because of her age could not be withdrawn from the superannuation system.

It would appear that she had been exploited by both the accountant and the software provider – and given very bad financial advice.

Case study provided by Melbourne SMSF Group

Question 9a: Do you agree with the obligations applying to both licensed and unlicensed product issuers and distributors?

We agree with the Proposals Paper that failing to extend the obligations to unlicensed product issuers and distributors 'has the potential to create gaps in the framework and still leave consumers vulnerable to certain products'. We also agree that minimising exclusions will minimize the competitive distortion between licensed and unlicensed product issuers and distributors. The examples of products and unlicensed entities given on page 15 of the Proposals Paper are alarming and precisely the types of investment that have caused serious problems and losses to investors in the past.

Question 9b: If they do apply to unlicensed issuers and distributors, are there any unlicensed entities that should be excluded from the obligations (for example, entities covered by the regulator sandbox exemption)? Who should be empowered to grant exemptions and in what circumstances?

By default, all unlicensed issuers and distributors should be subject to the obligations. However, we do not oppose ASIC being granted power to provide exemptions in limited circumstances on a case-by-case basis. Exemptions should only be granted where there is minimal risk posed to consumers, and the relevant entity has demonstrated it has robust compliance arrangements in place to protect its clients. Ideally, exemptions should only be available for products restricted to wholesale clients.[51]

ASIC should be empowered to impose strict conditions of relief, similar to the regulator sandbox exemptions, which are designed to:

- limit the risk of poor conduct or outcomes affecting a large number of consumers;
- assist consumers to understand the products and services being tested; and
- ensure that recourse is available in the event of a dispute.[52]

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[51] Australian Securities and Investments Commission, *RG176 Foreign financial service providers*, June 2012. Available at: http://download.asic.gov.au/media/1240973/rg176-published-29-june-2012.pdf. http://download.asic.gov.au/media/1240973/rg176-published-29-june-2012.pdf.

[52] Australian Securities and Investments Commission, *RG257 Testing fintech products and services without holding and AFS or credit licence*, December 2016, paragraph 257.79. Available at: http://download.asic.gov.au/media/4111792/rg257-published-15-december-2016.pdf.

ASIC should be able to withdraw or vary the relief provided with minimal consultation, should a significant risk to consumers become apparent.

Question 10a: Do you agree with the proposal that issuers should identify appropriate target and non-target markets for their products?

We agree with the proposal that issuers should identify appropriate target and non-target markets for their products. Overall, we agree with the FCA's sentiments that:

> *Firms should recognise that the identification of a target market or audience is crucial, not only for generating ideas for products, but for avoiding failures later in the value chain, whether or not an intermediated model is used–consideration of the target market should permeate all aspects of the product development and distribution.*[53]

We acknowledge concerns about the practical difficulties of implementing and enforcing such an obligation, which we discuss in further detail below. However, we are encouraged by the adoption of similar obligations in the United Kingdom and Europe, which indicate these practical hurdles can be overcome if sufficient guidance is provided by legislators and regulators.

Complexities of identifying target markets

There are clearly a number of complexities in defining a target and non-target market for a product. This is due not only to the broad range of financial and credit products available in the Australian market, but also the varied individual circumstances and needs of Australian consumers.

When purchasing a product, it is likely many Australians will have some of the identified target market's characteristics, but also some of the non-target market's characteristics. Determining whether a consumer falls within a target market will involve, at times, difficult value judgments. The other problem is apparently contradictory features of some individuals in a group. For example, the individual who states they have a high risk tolerance and are willing to bear loss of part or all of the investment but are nearing retirement.

Similarly, determining the factors that should be taken into account when identifying a target market will have its complexities and will require vigorous debate.

As noted in the Proposals Paper, there will also be an incentive for issuers to identify their target markets so broadly as to render them meaningless. The FCA recently found that some firms subject to similar obligations in the UK had identified a very broad target market (for example, 'any person that wants to manage their own investments'). According to the FCA, these firms were 'less able to articulate how their service supported their customers in making informed purchase decisions. They were also less able to identify and monitor the potential

[53] Financial Conduct Authority, *Retail Product Development and Governance – Structured Prodcut Review,* March 2012, paragraph 7.11. Available at: https://www.fca.org.uk/publication/finalised-guidance/fg12-09.pdf .

risks from their customers purchasing investments without a personal recommendation.'[54] While a broad target market may be acceptable for products suited to a broad range of customers, such as basic banking products, this will not be acceptable for others. The higher the degree of risk or complexity attached to a product, the narrower the target market should be. Guidance on the detail of firms' target markets, and what constitutes best practice, will be necessary to help avoid this situation.

It will also be important for issuers and distributors to ensure they are compliant with their obligations under anti-discrimination legislation when identifying target markets and designing products. According to the FCA, firms subject to the design and distribution obligations in the UK can help to avoid breaching equality legislation by 'Understanding the diverse needs of different groups of customers, and taking these into account when developing and marketing products'.[55] We anticipate that financial firms will have similar concerns in the Australia, and recommend that ASIC provide guidance as to how the design and distribution obligation will intersect with anti-discrimination law.

Overcoming the practical difficulties

Introducing an individual suitability test would be one method that could help to overcome the practical difficulties with identifying target markets. An individual product appropriateness test has been introduced in the European Union for product issuers and distributors at point of sale. This test requires an assessment of some of an individual's personal circumstances before making the product available.[56] However, we acknowledge that this option was dismissed by the Financial System Inquiry as too expensive and prescriptive, so we have instead focussed our discussion below on alternative solutions.

The FCA has helpfully set out a number of examples of best practice when identifying target markets, which could be used by ASIC to provide guidance to Australian firms. The FCA focussed on the importance of firms having programmes of consumer research, 'rather than simply carrying out research ad hoc':

> *This research that gave firms a better understanding of their target market(s) was that which sought to establish consumers' potential wants and needs, and to assess what the customer actually understood about the product (and so the potential risk of misunderstanding and a less than satisfactory customer outcome). We saw research that explored consumer understanding, attitudes, values and needs, as well as research that sought to test product literature. This worked better through a qualitative approach, where there could be in-depth exploration of responses, rather than through quantitative approaches, which used pre-determined response categories.*[57]

[54] Financial Conduct Authority, *Developments in the distribution of retail investments: Purchasing investments without a personal recommendation or with simplified advice,* July 2014, p. 7. Available at: https://www.fca.org.uk/publication/thematic-reviews/tr14-10.pdf.
[55] Financial Conduct Authority, *Retail Product Development and Governance – Structured Product Review,* March 2012, paragraph 7.7. Available at: https://www.fca.org.uk/publication/finalised-guidance/fg12-09.pdf .
[56] Financial System Inquiry, *Final Report,* December 2014, p. 203. Available at: http://fsi.gov.au/publications/final-report/.
[57] Financial Conduct Authority, *Retail Product Development and Governance – Structured Product Review,* March 2012, paragraph 7.4. Available at: https://www.fca.org.uk/publication/finalised-guidance/fg12-09.pdf .

The FCA noted that the evidence for identifying the target market their service was most likely to be appropriate for was not just collected via customer research. Evidence was gathered through a 'variety of channels, including formally commissioned consumer research, customer surveys, data from existing customers and data from third parties.' The FCA also made it clear that as part of the process of identifying the risks posed by the product to the target market, the issuer should consider stress-testing the product to identify how it might perform in a range of market conditions and how the consumer could be affected. This process should also consider the vulnerability and level of financial capability of the target market.[58]

Some issuers will no doubt argue that the detail required for a target market is unclear. However, the experience in the UK indicates that identifying a sufficiently detailed target market is achievable:

> *Some firms were able to define the characteristics of prospective customers very accurately and used this information to develop a detailed customer profile (or multiple profiles) that included granular information on factors such as their customers' age, wealth, level of financial knowledge and investment experience, and objectives. A small number of firms had also developed a profile for the kind of customers their service was not likely to be appropriate for. Firms that had undertaken this analysis used the results to inform the design of key elements of their service. This included the range of investments they made available to customers, the type and content of supporting information, their marketing strategy, and the controls they put in place to monitor the quality of customer outcomes. As a result, these firms could better ensure their services met genuine customer needs and were more likely to result in good customer outcomes.*[59]

We recommend that ASIC provide detailed guidance as to its expectations on the detail of firms' target markets, and what it considers best practice having regard to the FCA's experience, in its regulatory guides.

It should also be made clear to consumers whether they fall within or outside the identified target market for a particular product. The Proposals Paper is largely silent on the information required to be given by issuers and distributors to consumers about the target and non-target markets of products. We recommend that this information be prominently included in Product Disclosure Statements, prospectuses and other promotional material. Most consumers would be helped by seeing a description of the types of consumers that the issuer considers would be suited to the product, and (perhaps more so) a list of consumers who would not be suited to the product.

[58] Financial Services Authority, *The responsibility of providers and distributors for the fair treatment of customers,* 2006, paragraph 4.5. Available at: http://www.fsa.gov.uk/pubs/discussion/dp06_04.pdf.
[59] Financial Conduct Authority, *Developments in the distribution of retail investments: Purchasing investments without a personal recommendation or with simplified advice,* July 2014, p. 9. Available at: https://www.fca.org.uk/publication/thematic-reviews/tr14-10.pdf.

Question 10b: What factors should issuers have regard to when determining target markets?

We agree with the overall proposition that when determining whether a target market is appropriate, issuers should have regard to whether the product is satisfying (or will satisfy) the needs (and risk aversion) of the target market, and the ability of consumers in the target market to understand the key features of the product.

The factors issuers should have regard to when determining target markets will vary according to the complexity and type of product being offered. This aligns with the approach of the FCA, which stated that:

> *When undertaking product design we would typically expect a firm to identify a target market. However, the way this should be done, and the level of detail that should be gone into, will depend on the nature of the product and its general risk profile… the provider may be able to meet this standard by identifying for whom the product is not suitable. It may also, where appropriate, be able to identify a range of alternative target markets, an extremely broad target market, or a hypothetical market. There may even be circumstances in which a firm could identify the whole market as its target market, although firms should be wary of using this as an alternative to giving due consideration to the issue of the target market.* [60]

Having regard to these matters will necessarily involve assessing the characteristics of the target class and the products themselves. We would expect that an assessment of the characteristics of the target class of consumer would ordinarily include consideration of the consumer's:

- proximity to retirement and employment status;
- financial situation (including tax situation, income and assets);
- financial literacy and financial capability/experience;
- access to financial information;
- risk profile (including capacity and willingness to bear loss);
- capacity to pay (or repay);
- investment objectives;
- ability to hold the product for the full term;
- the minimum investment amount for the product (where applicable); and
- for insurance – factors requiring consumers in the target market to benefit from the significant features of the product, such as family structure, age, asset ownership (see our response to Question 11 for further details).

Following an assessment of the target market's characteristics, we would expect a corresponding assessment of the characteristics of the product, if necessary, including:

[60] Financial Services Authority, *Responsibilities of providers and distributors for the fair treatment of customers – Feedback on DP06/04,* July 2007, paragraph 2.10. See also: Financial Services Authority, *The responsibility of providers and distributors for the fair treatment of customers,* 2006, paragraph 4.5. Available at: http://www.fsa.gov.uk/pubs/discussion/dp06_04.pdf.

- the product’s risk and return profile;
- the product’s likely performance (including considerations of economic situation); and
- whether any terms or conditions would prevent the targeted consumers from benefiting.[61]

We strongly oppose leaving it to industry to determine what is and isn’t appropriate for consideration when determining a target market, as suggested by the Financial System Inquiry.[62] Appropriate standards to supplement the principles-based obligation should be created by ASIC, not the industry.

As noted above, there are some complexities associated with defining target markets given the variety of individual needs and circumstances of Australian consumers. One of the more difficult areas to assess will be a consumer’s risk profile, as firms may need to make assumptions about consumers’ risk profiles based on demographic information.

The assessment of a consumer’s capacity to pay (or repay) will also be somewhat complex. Capacity to pay is a critical feature of some insurance products and sometimes associated with absence of benefit. The obverse of this is capacity to bear loss. It may not matter to some classes of consumers if their investments result in losses, but it will be critical to others. Both of these may (for many people) be implicit in the references to proximity to retirement or income and wealth but they should be made explicit. The question is – how much loss is too much loss?

Question 11: For insurance products, do you agree the factors requiring consumers in the target market to benefit from the significant features of the product? What do you think are significant features for different product types (for example, general insurance versus life insurance)?

We strongly agree that consumers in the target market should benefit from the significant features of the product. We have listed the significant features for different insurance product types below. However, the listed features should be considered a ‘starting point’. Insurers should undertake market research to consult with consumers to establish the key features of products from consumers’ perspectives.

<u>*General insurance*</u>

A. Add-on insurance

We have significant concerns about add-on insurance products, particularly those sold in car yards that require very little active engagement by consumers during the purchasing process. These products are often ‘bundled’, and many consumers are unaware they have even purchased the product. Consumer Action Law Centre’s website DemandARefund.com found that 21% of consumers who claimed refunds through the site were not aware that they had even purchased add-on insurance. ASIC’s reports on add-on insurance sold in car yards show

[61] Financial Conduct Authority, *Retail Product Development and Governance – Structured Product Review,* March 2012, paragraph 7.12. Available at: https://www.fca.org.uk/publication/finalised-guidance/fg12-09.pdf.
[62] Financial System Inquiry, *Final Report,* December 2014, p. 198. Available at: http://fsi.gov.au/files/2014/12/FSI_Final_Report_Consolidated20141210.pdf.

these extremely high-cost products being sold to people who do not stand to benefit from the significant features of the product.[63] ASIC has described the widespread sale of add-on insurance in car yards as 'a market that is failing consumers.'[64]

There are a number of different types of add-on insurance. Consumer Credit Insurance (**CCI**) is insurance that covers you if something happens that affects your capacity to meet the payments on your loans and other credit. CCI usually covers situations of unemployment, illness, involvement in an accident, and death.[65] "GAP insurance" (also known as Motor Equity Insurance) is insurance against a shortfall that may occur in the event that a vehicle is stolen or written off, and the Comprehensive Motor Vehicle Insurance payout does not cover the loan balance outstanding on the relevant finance agreement.[66] Warranties are also offered by car yards which either duplicate the Australian Consumer Law or have significant exclusions. One example is "mechanical breakdown insurance", or motor breakdown insurance, which provides some cover for the repair or replacement of specific parts of a car if there is an unexpected mechanical failure.

We have provided examples of consumers failing to benefit from the significant features of add-on insurance below:

- *Consumer Credit Insurance*
    - *Unemployment cover:* We have seen unemployment cover sold to people who are ineligible to claim on it because they are self-employed, employed casually or part-time (generally under 20 hours per week) or unemployed.
    - *Disability cover:* We have seen disability cover sold to people who are ineligible to claim because they have pre-existing conditions, are on the disability support pension or are unemployed. We have also seen it sold to people who already have income protection insurance (for example, in their superannuation).
    - *Age limits:* Older people cannot claim on some CCI policies, for example, some policies will not cover anyone over the age of 60 years.
- *GAP insurance*
    - *No or little gap:* GAP insurance has been sold to people who have comprehensive car insurance with an agreed value that will cover the cost of the loan, or will leave a very small gap. The 'no gap' problem also arises where someone has paid a large deposit and there is little or no gap for much of the loan period.
    - *No car and/or no comprehensive cover*: We have seen consumers sold GAP insurance when they do not own a car and/or comprehensive cover, meaning the GAP insurance policy will never pay out.
- *Mechanical breakdown insurance*
    - *Distance travelled limit:* If a car is purchased that has already exceeded the number of kilometres under the 'distance travelled' condition, the consumer will be ineligible to claim under a mechanical breakdown insurance policy.

[63] ASIC Reports 470, 471 (life insurance) and 492.
[64] ASIC Report 492.
[65] http://www.moneyhelp.org.au/your-debt-options/claiming-credit-insurance/
[66] https://www.strattonfinance.com.au/insurance/loan-protection/gap-insurance.aspx

- *Warranties*
    - *Duplicating ACL guarantees:* There is often overlap between the 'protections' offered by add-on warranties and the existing consumer guarantees under the Australian Consumer Law on new and used cars.

B. Home building and contents

Home building insurance and contents insurance have a range of features that may or not be suitable for a consumer depending on their circumstances. Below are the significant features of home building and contents policies that should be considered when defining the target market:

- *Coverage for major events:* Including theft, accidental damage, storm, flood, cyclone, fire and bushfire, and actions of the sea.
- *Repair and replacement type:* Whether the insurer will settle through repair, replacement or by paying out on the claim.
- *For total loss:* Whether there is complete replacement or a limit on the benefit paid.
- *Major exclusions:* Whether damage caused by flood, storm, bushfire or cyclone, items left in the open air, or deliberate damage is excluded.
- *Temporary accommodation:* Whether temporary accommodation is offered and for what period.
- *Valuable items:* Whether valuable items are covered, and the extra costs and/or conditions associated with coverage.[67]

C. Car insurance

Below are the significant features of car insurance that should be considered when defining the target market that is likely to benefit from a policy:[68]

- *Type of policy:* Third-party property, third-party property, fire and theft or comprehensive coverage.
- *Excess payable:* Whether the excess exceeds or is near the value of the insured vehicle.
- *Comprehensive coverage:* Whether a replacement car, or an agreed or market value for the vehicle is payable if the vehicle is written off.

D. Travel insurance

Significant features that should be considered when defining a target market for travel insurance include:

- *Age limits and premiums:* Policies commonly limit the age of the person covered to a minimum and maximum age, and premiums are higher for older people—in some cases premiums start to increase at 50 years of age.

[67] For more information, see CHOICE, *Home and contents insurance buying guide,* September 2016. Available at: https://www.choice.com.au/money/insurance/home-and-contents/buying-guides/home-and-contents-insurance.
[68] For more information, see CHOICE, *Car insurance buying guide,* August 2016. Available at: https://www.choice.com.au/money/insurance/car/buying-guides/car-insurance.

- *Cancellation cost exclusions:* Some policies will not cover trip cancellation for certain reasons. This will be significant where a person is travelling to a region where cancellation for one or more of the excluded reasons is more likely (for example, where a person is travelling to an area where there is a disease epidemic or a war zone).
- *Mental illness exclusions:* Most policies will not pay a claim where the claim is a direct or indirect result of a mental illness.
- *Pre-existing conditions exclusion:* Most policies will not pay a claim where the claim is a direct or indirect result of a pre-existing medical condition.[69]
- *Lost or stolen property:* Some policies have strict requirements for the supervision of luggage and personal effects, which may not be suitable for some budget travellers.

Life insurance

We have seen numerous examples of life insurance products being marketed towards inappropriate target markets. We have set out the significant features of add-on life insurance, funeral insurance and income protection insurance that should be considered when determining a target market below.

A. *Add-on life insurance*

As with the add-on insurance described above, we have seen significant problems with add-on life insurance, particularly life insurance sold in car yards. ASIC's recent review suggests that car yard life insurance 'is poor value for money' and 'can be sold when it is not necessary',[70] indicating that insurers and distributors are currently failing to identify appropriate target markets for their products.

The most common significant life insurance components of add-on insurance are cover for accidental death and trauma (major illness).[71] Below are the significant features that should be considered when defining the target market for add-on life insurance:

- *Death benefits for people with no dependants:* Add-on life insurance with death cover should not be sold to people who have no dependants, as they have no need or desire to provide for anyone's future. This is particularly true for young people without children.
- *Cover duplicated under other life insurance:* Add-on life insurance often replicates cover that many people already have under other life insurance, particularly insurance held in their superannuation. This is the case for both accidental death and trauma (major illness) cover. A person should be outside the target market for add-on life insurance where the death or trauma cover replicates cover they already have.[72]

[69] For more information, see CHOICE, *Travel insurance buying guide,* July 2016. Available at: https://www.choice.com.au/travel/money/travel-insurance/buying-guides/insurance.

[70] Australian Securities and Investments Commission, *REP 471 The sale of life insurance through car dealers: Taking consumers for a ride*, 29 February 2016. Available at: http://www.asic.gov.au/regulatory-resources/find-a-document/reports/rep-471-the-sale-of-life-insurance-through-car-dealers-taking-consumers-for-a-ride/. http://www.asic.gov.au/regulatory-resources/find-a-document/reports/rep-471-the-sale-of-life-insurance-through-car-dealers-taking-consumers-for-a-ride/.

[71] Ibid.

[72] See our response to Question 1b for more information regarding duplicate cover.

B. Funeral insurance

Significant features that should be considered when defining a target market for a funeral insurance product include**:**

- *Age*: Funeral insurance will generally be inappropriate for young people, and there should be a minimum age for the target market. In our view funeral insurance should not be sold to people under the age of 50.
- *Stepped or level premiums:* Whether funeral insurance has a level or stepped premium is significant, as it will often determine whether someone can continue to afford it throughout their life.
- *Premium cap:* Some better policies have a 'cap' and a person will no longer pay premiums once their total payments reach the cap. This usually improves the value of the product.

C. Income protection insurance[73]

Income protection policies are designed to meet the costs of 'living', rather than ensuring family members receive a payout after death. The significant features of income protection insurance are set out below:

- *Cancellable policies:* Some insurers may reassess the insured's health or other factors on each renewal, possibly raising premiums or refusing to continue cover.
- *Guaranteed Future Insurability:* This is a benefit that allows the insured to increase the level of cover without further underwriting. This is important if the person's circumstances change due to events like buying a home or having a child.
- *Offset clauses:* These clauses allow insurers to reduce payouts if the insured has other income (for example, sick pay or Centrelink benefits).
- *Group insurance provided through superannuation:* the agreement is between the fund trustee and insurer. This may make the claim and payout less straightforward. Waiting periods and benefits periods can vary as a result.
- *Occupation covered:* Some policies pay out if the insured unable to perform their normal occupation, while others only pay if the insured can't perform any occupation for which they are suited by education, training or experience.

In determining whether a target market will benefit from the features of an insurance policy (either general or life), and when notifying consumers about whether they fall within the target market, we recommend that insurers consider implementing 'product scorecards' about their claims handling. These scorecards would include information on the average value of payouts, claims acceptance rates and the ratio of premiums to payouts for people within and outside the target market.

[73] For more information, see CHOICE, *Income protection insurance buying guide,* March 2017. Available at: https://www.choice.com.au/money/insurance/life/buying-guides/income-protection-insurance.

Question 12: Do you agree with the proposal that issuers should select distribution channels and marketing approaches for the product that are appropriate for the identified target market? If not, please explain why with relevant examples.

We agree that issuers should select distribution channels and marketing approaches for the product that are appropriate for the identified target market. As noted above, there are complexities involved with identifying appropriate target markets. However, with guidance in the legislation and in ASIC regulatory guides about expectations on issuers, having regard to examples of best practice provided by the FCA, we believe these complexities can be addressed.

We particularly support the Proposal Paper's statement that 'issuers should not select distribution channels where staff employed through that distribution channel are unlikely to have the skills and knowledge' necessary to distribute the product safely. We also agree that distribution channels whereby consumers can acquire the product without active engagement are also unlikely to be appropriate for most consumers, regardless of the target market.[74]

A typical example of a product sold via a distribution channel without active engagement that is inappropriate for most consumers is consumer credit insurance (CCI). The claims ratio for CCI is only 5%, indicating the product has minimal value for most Australians who purchase it.[75] Since January 2016, Consumer Action has operated an online service to help people get refunds for mis-sold CCI. Consumer Action's website, DemandARefund.com, has helped get refunds of almost $500,000. Significantly, 27% of claimants on the site indicated that they believed the CCI was mandatory for them to obtain the loan or credit card, and 21% were unaware that they had even purchased the CCI.

Case study – Consumer Credit Insurance

Bob* (name changed) bought a new car and finance was arranged through the car dealer. It was his 'dream car' and he was very excited that he and his wife had been approved for finance. The car dealer also sold him two insurance policies (consumer credit and gap insurance) totalling $19,196.60. He did not realise he had agreed to buy this optional insurance because he wasn't asked about it. The insurance took his loan amount from $61,491.72 to $80,688.32 and represented 24% of the loan amount. Interest on the insurance alone would have equated to $9,998.98 over the course of the loan, meaning he would have spent $29,195.58 on add-on insurance for a car that cost $48,774. Bob did not receive Product Disclosure Statements for the insurance policies and did not know what they covered and what they did not cover.

Case study provided by Consumer Action Law Centre

[74] The Treasury, *Design and Distribution Obligations and Product Intervention Power*, 13 December 2016, p. 20. Available at: http://www.treasury.gov.au/ConsultationsandReviews/Consultations/2016/Design-and-distribution-obligations-and-product-intervention-power.

[75] Australian Securities and Investments Commission, *Report 492: A market that is failing consumers – the sale of add-on insurance through car dealers*, September 2016. Available at: http://download.asic.gov.au/media/4042960/rep-492-published-12-september-2016-a.pdf.
http://download.asic.gov.au/media/4042960/rep-492-published-12-september-2016-a.pdf.

Question 13: Do you agree that issuers must have regard to the customers a distribution channel will reach, the risks associated with a distribution channel, steps to mitigate those risks and the complexity of the product when determining an appropriate target market? Are there any other factors that issuers should have regard to when determining appropriate distribution channels and market approach?

We agree that when determining whether a distribution channel and marketing approach is appropriate for a product, issuers must have regard to the matters set out in Detailed Proposal 2.[76] In particular, it is imperative that issuers have regard to the extent to which consumers are engaged through that distribution channel, and how the distributor intends to market the product (and whether that form of marketing is appropriate).

Firms should also be required to undertake thorough due diligence when selecting distributors. We agree with the FCA that initial due diligence should 'include an assessment of any risks posed to the fulfilment of the firm's legal and regulatory responsibilities'.[77] We expect that due diligence checks would include an assessment of the distributor's:

- staff expertise and experience
- key person competencies
- compliance arrangements (including licensing arrangements)
- history of compliance problems or regulator action
- marketing strategies
- other products being distributed
- organisational reputation

For example, we would expect that a bank would undertake due diligence checks on potential mortgage brokers that will be distributing its mortgage products. This would include an assessment of the mortgage broker's staff knowledge of its product, arrangements in place to comply with the National Credit Act and other relevant legislation, previous marketing material and any history of non-compliance.

Question 14: Do you agree with the proposal that issuers must periodically review their products to ensure the identified target market and distribution channel continues to be appropriate and advise ASIC if the review identifies that a distributor is selling the product outside of the intended target market?

We agree that issuers should periodically review their products to ensure the identified target market and distribution channel continues to be appropriate and advise ASIC if the review identifies that a distributor is selling the product outside of the intended target market.

We recommend that reviews be undertaken at least every 6 months. ASIC should provide specific guidance to firms on its expectations of the regularity of reviews.

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[76] The Treasury, *Design and Distribution Obligations and Product Intervention Power*, 13 December 2016, p. 21. Available at: http://www.treasury.gov.au/ConsultationsandReviews/Consultations/2016/Design-and-distribution-obligations-and-product-intervention-power.

[77] Financial Conduct Authority, *Retail Product Development and Governance – Structured Prodcut Review,* March 2012, paragraphs 10.7-10.8. Available at: https://www.fca.org.uk/publication/finalised-guidance/fg12-09.pdf.

We note that a requirement to advise ASIC if the review identifies that a distributor is selling the product outside of the intended target market could be incorporated into the existing Australian Financial Services Licensee breach reporting regime. This would have the benefit of using existing infrastructure, and will be a process familiar to most financial services licensees.

We also recommend that issuers be required to act swiftly if a review identifies distribution issues. We agree with the FCA's recommendations that firms should act on their assessments of distributors, which could include amending consumer or adviser literature for future product tranches, providing enhanced training for distributors, ceasing to use a particular distribution channel, or limiting distribution to specific channels.[78]

Question 15: In relation to all the proposed issuer obligations, what level of detail should be prescribed in legislation versus being specified in ASIC guidance?

We recommend legislation be principles based, with examples provided in the explanatory memorandum. Specific guidance can be issued by ASIC in regulatory guides. However, legislation should give ASIC guidance about expectations for different types of issuers and distributors. For example, if different factors are to be taken into account for insurance products, as opposed to investment products, this should be set out in the legislation.

Question 16: Do you agree with the proposal that distributors must put in place reasonable controls to ensure that products are distributed in accordance with the issuer's expectations?

Yes. See Question 19 below for comments regarding the chain of responsibility between issuers and distributors.

Question 17: To what extent should consumer be able to access a product outside of the identified target market?

We do not oppose consumers outside of the identified target market being permitted to access a product (although not to the extent that retail clients would be permitted access to wholesale products). If consumers are permitted access to a product not designed for them, there must be appropriate safeguards put in place to protect these consumers. These safeguards and warnings should be designed having regard to behavioural economics principles, for example by changing the 'choice environment'.[79] We want to avoid 'tick box' compliance and opt-outs that require minimal consumer engagement in the process.

We reiterate the complexities of ensuring that a consumer is aware whether they are outside the target market. Particularly where literacy (financial, numerical or otherwise) is an issue, there will need to be innovative approaches to disclosure to ensure that consumers are aware of the product's appropriate target market, and whether they are part of it.

[78] Ibid.
[79] Financial Conduct Authority, *Applying behavioural economics at the Financial Conduct Authority,* April 2013, p. 9. Available at: https://www.fca.org.uk/publication/occasional-papers/occasional-paper-1.pdf.

One potential option is to require an opt-in mechanism for consumers outside the target market who wish to access a product. Typically, an opt-in process requires a consumer to proactively opt in to purchase a product after 48 hours.[80] However, we acknowledge this approach may be impractical for time sensitive investments such as contracts for difference (**CFDs**) and shares. A different response may be required for different products, but overall we support the concept of introducing a 'circuit breaker' that would require active engagement by the consumer.

Question 18: What protections should there be for consumers who are aware they are outside the target market but choose to access a product regardless?

In addition to our comments in response to Question 17 above, it is important that consumers who are aware they are outside the target market but choose to access a product regardless are not denied protections elsewhere in the framework. For example, these consumers should not be precluded from making a claim against the issuer or distributor for misleading or unconscionable conduct.

Question 19: Do you agree with the proposal that distributors must comply with reasonable requests from the issuer related to the product review and put in place procedures to monitor the performance of products to support the review? Should an equivalent obligation also be imposed on advised distributors?

We broadly agree with the proposal that distributors must comply with reasonable requests from the issuer related to the product review and put in place procedures to monitor the performance of products to support the review.

However, distributors should not be wilfully blind when issuers fail to identify a target market appropriately or provide inadequate instructions. The FCA found that some firms (particularly those using an intermediated distribution model) did not have a clear enough idea of a target market and of its needs and wants–and so could not communicate this to distributors.[81] There will need to be a clear chain of responsibility that ensures distributors can't simply turn a blind eye and disclaim responsibility when they ought to have been aware of breaches by the issuer.

See Question 8 for our comments in relation to personal financial advice and advised distributors.

Question 20: In relation to all the proposed distributor obligations, what level of detail should be prescribed in legislation versus being specified in ASIC guidance?

See Question 15.

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[80] For example, in the vocational education sector, a provider must not accept a 'Request for a VET FEE-HELP loan' form from a person unless two business days have passed from the date and time the person enrolled. See Department of Education and Training, *VET FEE-HELP Reform Factsheet,* July 2016. Available at: https://docs.education.gov.au/system/files/doc/other/160901_vet_fee-help_reform_factsheet.pdf.

[81] Financial Conduct Authority, *Retail Product Development and Governance – Structured Prodcut Review,* March 2012, paragraphs 7.3. Available at: https://www.fca.org.uk/publication/finalised-guidance/fg12-09.pdf.

Question 21: Do you agree with the obligations applying 6 months after the reforms receive Royal Assent for products that have not previously been made available to consumers? If not, please explain why with relevant examples.

Yes.

Question 22: Do you agree with the obligations applying to existing products in the market 2 years after the reforms receive Royal Assent? If not, please explain why with relevant examples and indicate what you consider to be a more appropriate transition period.

We disagree with the obligations applying to existing products in the market 2 years after the reforms receive Royal Assent. Arguably, firms should understand their existing products even better than their new products, so we are not convinced the commencement date should be delayed for such a lengthy period. This is particularly given the ongoing review obligations under the design and distribution obligations. We recommend that the obligations apply to existing products 12 months after the reforms receive Royal Assent.

We note that it is unclear from the Proposals Paper how the obligations will apply to existing contracts, as opposed to existing products. In our view, existing contracts for products that breach the design and distribution obligation should be voidable in this instance. Consumers should also notified by the issuer or distributor of their right to void their contract and seek redress via external dispute resolution.

PRODUCT INTERVENTION POWER

Question 23: Do you agree that ASIC should be able to make interventions in relation to the product (or product feature), the types of consumers that can access a product or the circumstances in which a consumer can access the product. If not, please explain why with relevant examples.

Yes. Please see Question 24 for our comments regarding additional types of interventions ASIC should be able to make.

Question 24: Are there any other types of interventions ASIC should be able to make (for example, remuneration)?

We recommend that the types of interventions ASIC should be able to make align with ASIC's current approach to enforceable undertakings. Currently, enforceable undertakings enable ASIC to make interventions in relation to compliance and monitoring. The undertaking must specify how the business will address the conduct ASIC is concerned about and ensure it does not occur again. ASIC must also be satisfied that the business has adequate arrangements for monitoring how the undertaking is implemented and reporting to ASIC. Enforceable undertakings can also require the business to undertake rectification and compensatory action and provide corrective notices, among other things.[82]

[82] Australian Securities and Investments Commission, RG 100 Enforceable Undertakings, February 2015. Available at: http://download.asic.gov.au/media/2976014/rg100-published-19-february-2015.pdf.

In our view, enforceable undertakings have been a very effective enforcement tool. In determining the scope of the product intervention power, the success of ASIC's enforcement outcomes via enforceable undertakings should be taken into account. The product intervention power should provide ASIC with the flexibility to fix the root cause of problems, rather than just patch up the symptoms.

ASIC should be empowered to address the remuneration and qualifications of issuer's staff and distributors. Conflicted remuneration clearly encourages bad behaviour in the distribution chain. This risk of harm created by conflicted remuneration was acknowledged during the Future of Financial Advice (**FOFA**) reforms process. Unfortunately, the FOFA ban on conflicted remuneration has so many exemptions that we question whether it has had any significant impact on the overall sales cultures of Australian banks and credit providers. A number of international studies have also identified a strong correlation between target-based sales incentives and consumer harm.[83] Conflicted remuneration ultimately distorts the behaviour of sales staff and encourages the hard-selling of products people don't want or need. Selling products is elevated above considerations of the well-being of customers. This can lead to Australians suffering significant financial harm. Bank staff themselves have provided examples of a 'target-based, sales-driven culture where their perception is that the imperative is not customer service *per se* but to sell.'[84]

ASIC has experience in regulating problematic remuneration structures, which makes limiting the range of interventions even more perplexing. In fact, ASIC recently announced that it will prohibit 'flex commissions' in the car finance market. ASIC describes flex commissions as "common in car finance but not generally found in other markets. Flex commissions allow car dealers to arrange car loans at a higher interest rate than the lowest available rate (700 basis points higher – or more), and thereby earn a much higher commission. As a result, some consumers can end up paying thousands of dollars more in interest charges over the life of the car loan."[85] ASIC has prohibited flex commissions by using its powers to create legislative instruments under section 109(3)(d) of the National Credit Act. We note that ASIC's powers under this legislation are far more limited than the proposed product intervention powers.

Question 25: Do you agree that the extent of a consumer detriment being determined by reference to the scale of the detriment in the market, the potential scale of the detriment to individual consumers and the class of consumers impacted? Are there any other factors that should be taken into consideration?

We strongly support ASIC being enabled to make interventions when a risk of consumer harm is identified, rather than in response to a demonstrated or suspected breach of the law. This will allow ASIC to intervene before harm has occurred, and prevent harm to consumers. This power should

[83] A summary of this research is available in Consumer Action Law Centre's submission to the Retail Banking Review Terms of Reference at pages 3-5: http://retailbankingremreview.com.au/wp-content/uploads/2016/10/Consumer-Action-Law-Centre-Submission.pdf.
[84] Stephen Sedgwick AO, *Retail Remuneration Review – Issues Paper*, 17 January 2017. Available at: http://retailbankingremreview.com.au/wp-content/uploads/2017/01/Issues-Paper_Retail-banking-remuneration-review.pdf.
[85] Australian Securities and Investments Commission, *17-049MR ASIC acts to address unfair outcomes from flex commissions in the car finance market,* 3 March 2017. Available at: http://asic.gov.au/about-asic/media-centre/find-a-media-release/2017-releases/17-049mr-asic-acts-to-address-unfair-outcomes-from-flex-commissions-in-car-finance-market/.

not be seen as a 'last resort', but instead be used as a pro-active enforcement tool that protects consumers from risky products before widespread harm occurs. Intervention at the 'risk' stage rather than actual stage is vital for vulnerable consumers as the long term effects of any detriment will likely be greater for them.

We agree that the extent of a consumer detriment should be determined by reference to the scale of the detriment in the market, the potential scale of the detriment to individual consumers and the class of consumers impacted. We are particularly supportive of ASIC being enabled to intervene whenever the detriment is significant either on a market-wide basis or an individual basis. This will allow ASIC to address misconduct directed at large numbers of low-income consumers who might suffer small losses in dollar terms, but which have a disproportionate impact on their financial capacity.

Example – Nimble payday loans[87]

Following a significant ASIC investigation inn 2016, payday lender Nimble Australia Pty Ltd (Nimble) was required to refund over 7,000 customers more than $1.5 million after ASIC had concerns that Nimble was failing to meet its responsible lending obligations. ASIC identified significant deficiencies in Nimble's compliance with the responsible lending laws when providing loans of short duration to consumers. While the refund amounted to an average of only $214.29 per person, this is likely to have had a relatively significant impact on their customers' financial capability.

Example – Inhouse Finance Group warranties[88]

Inhouse Finance Group (Sydney) Pty Ltd (Inhouse Finance Group) entered into an enforceable undertaking with ASIC requiring it to refund more than $400,000 to 177 consumers. This means the average refund amount per consumer will be approximately $2,260. The refund followed an ASIC surveillance which found that the car financier charged consumers an interest rate higher than the maximum allowable under the National Credit Act.

According to ASIC's media release, Inhouse Finance Group provides loans for cars purchased from Best Buy Autos in Sydney. In doing so, it required consumers to purchase a warranty product if they were unable to pay an 80 per cent deposit. The cost of the warranty was included in the amount borrowed under the loan contract and this cost should

[87] Australian Securities and Investments Commission, *16-089MR Payday lender Nimble to refund $1.5 million following ASIC probe,* 23 March 2016. Available at: http://asic.gov.au/about-asic/media-centre/find-a-media-release/2016-releases/16-089mr-payday-lender-nimble-to-refund-15-million-following-asic-probe/.

[88] Australian Securities and Investments Commission, *17-037MR Car loan provider Inhouse Finance Group to repay more than $400,000 to consumers,* 21 February 2017. Available at: http://asic.gov.au/about-asic/media-centre/find-a-media-release/2017-releases/17-037mr-car-loan-provider-inhouse-finance-group-to-repay-more-than-400-000-to-consumers/.

have been included in the calculation of the annual percentage interest rate. The miscalculation led to some consumers being charged an annual interest rate of up to 90 per cent on their car loans. The maximum allowed under the National Credit Act is 48 per cent.

Inhouse Finance Group is required to contact affected consumers to explain what refund or reduction in repayments they might be entitled to.

Question 26: Do you agree with ASIC being required to undertake consultation and consider the use of alternative powers before making an intervention? Are there any other steps that should be incorporated?

We do not believe ASIC should be required to undertake extensive consultation before making an intervention. In our view, extensive consultation would hinder ASIC's ability to respond to risks to consumers in a timely fashion. Consultations are a time consuming process, which industry can use as a way to stave off much-needed reforms, or harm mitigation. Requiring extensive consultation would detract from the pre-emptive, preventive and timely aims of the powers identified as necessary by the Financial Systems Inquiry. ASIC should be empowered to act quickly, and should not be hamstrung by extended consultation periods.

We note that in the United Kingdom, the FCA is able to make temporary product intervention rules (**TPIRs**) for a period of 12 months without any prior consultation.[89] TPIRs are made where the FCA identifies a significant risk to consumers which requires prompt action. The FCA consulted with stakeholders once when developing its policy on the use of the TPIR power.

According to the FCA website, some of the instances in which the FCA might consider making temporary rules include:

- where a product is in serious danger of being sold to the wrong customers, for instance where complex or niche products are sold to the mass market;
- where a non-essential feature of a product seems to be causing serious problems for consumers; and
- where a product is inherently flawed.

During this period of intervention, FCA either consults on a permanent remedy or works to resolve the problem another way.

In our view, a similar approach is warranted by ASIC when a serious danger of harm to consumers is identified by ASIC. We recommend that levels of consultation should ultimately be commensurate with the assessed risk of detriment to consumers. Consultations between ASIC and other regulators, such as APRA, should be permitted but also not be mandated. Co-operation between regulators is an internal matter, and the need to consult should be determined on a case-by-case basis by ASIC.

[89] Financial Conduct Authority, *FSA confirms approach to using temporary product intervention rules that will be used by the FCA,* 31 March 2013. Available at: https://www.fca.org.uk/news/press-releases/fsa-confirms-approach-using-temporary-product-intervention-rules-will-be-used.

In terms of the requirement to consider the use of alternative powers, it should be explicit that ASIC may, but is not required, to use alternative powers before making an intervention. The intervention power should not be considered a last resort, but simply another ASIC enforcement tool. ASIC should consider which enforcement tool will deliver the most effective and timely outcomes for consumers, as it already does. ASIC should have wide discretion how to respond, depending on the nature and extent of the actual or prospective detriment assessed.

Question 27: Do you agree with ASIC being required to publish information on intervention, the consumer detriment and its consideration of alternative powers? Is there any other information that should be made available?

We agree with ASIC being required to publish information on intervention, the assessed consumer detriment and its consideration of alternative powers. However, we recommend that ASIC also be required to 'name and shame' companies where practicable, particularly in the event of an individual intervention. We acknowledge that naming affected persons or companies could be difficult if a wide class of providers or products were covered by the intervention, hence we would limit the requirement to naming companies and individuals 'where practicable'. Any previous interventions against the same entities or similar products should also be highlighted.

ASIC should also be empowered to require affected companies to notify relevant clients of an intervention and their rights to redress, including access to dispute resolution services via EDR. Communication plans should also be subject to approval by ASIC. This power aligns with ASIC's current approach to enforceable undertakings, whereby affected companies are required to contact affected customers using an ASIC-approved communications plan. A recent example is provided below.

Example – Cash Converters payday loans[90]

Following an ASIC investigation, payday lender Cash Converters entered into an enforceable undertaking that required the lender to refund $10.8 million to consumers who received small amount loans under approximately 118,000 small amount credit contracts. Cash Converters entered into the enforceable undertaking after ASIC concerns that the lender failed to make reasonable inquiries into consumers' income and expenses, and failed to take appropriate steps to verify this information. Instead of assessing the actual expenses recorded in a consumer's bank statements, Cash Converters applied an internally-generated assumed benchmark that had no relationship to the real expenses of the individual consumer.

Consumers who had two or more small amount loans in the 90 days before taking out another small amount loan through Cash Converters' website during the period 1 July 2013 to 1 June 2016 were required to be contacted by Cash Converters with information about their refund. Cash Converters was also required to have its communications plan approved by ASIC.

Question 28: Do you agree with interventions applying for an initial duration of up to 18 months with no ability for extensions? Would a different time frame be more appropriate? Please explain why.

We strongly oppose interventions being restricted to an initial duration of up to 18 months with no ability for extensions. We recommend that an intervention continue until ASIC, or the Government, decides that the risk of consumer harm has been addressed and the intervention order is safe to remove.

If interventions are limited to an 18-month period, there needs to be a clear process for getting the issue on the Government agenda and resolving interventions. For example, the expiry of an intervention could trigger a determination or other obligation on the relevant Minister. We note that in the UK, the FCA is empowered to make temporary interventions without consultation of up to 12 months, but is able to make permanent rules with consultation with affected parties. The watered-down version proposed in the Proposals Paper for Australia would require ASIC to undertake extensive consultation without any power to make permanent rules. The proposal is, in a sense, 'the worst of both worlds'.

As demonstrated by the examples below, it generally takes the Government much longer than 18 months to implement reforms in this industry.

[90] Australian Securities and Investments Commission, *16-380MR Cash Converts to pay over $12M following ASIC probe,* 9 November 2016. Available at: http://asic.gov.au/about-asic/media-centre/find-a-media-release/2016-releases/16-380mr-cash-converters-to-pay-over-12m-following-asic-probe/.

Example – Future of Financial Advice reforms[92]

The implementation of the FOFA reforms have been a prolonged battle, which was seen the process drag out for more than 7 years. These reforms were designed to address commissions, conflict of interest, the best interest duty, scaled advice and the role of advisers, among other matters.

The abbreviated timeline for the implementation of the FOFA reforms is set out below:

- **November 2009 -** The Ripoll inquiry issues a report recommending a review of the financial advisers and conflicted remuneration.
- **April 2010** - Labor government announces a FOFA reform committee.
- **August - October 2011** - Labor government tables draft legislation
- **June 2012** - FOFA legislation passed by Parliament
- **March 2014** - the Government introduces legislation to amend FOFA.
- **November 2014** – most of the proposed amendments were disallowed by the Senate
- **March 2016** – further FOFA amendments passed by the Parliament.

Example – Credit card reforms to ban unsolicited offers of credit limit increases [93]

On 1 July 2012, a number of reforms to credit card regulation came into effect. Among other things, these reforms banned unsolicited offers to increase credit card limits. The timeline for the implementation of this particular reform is set out below:

- **2008:** The Council of Australian Governments (COAG) agreed to implement a two-phase plan to transfer credit regulation to the Commonwealth and introduce new Commonwealth regulation to enhance consumer protection.
- **2009**: The *National Consumer Credit Protection Act 2009* was introduced and implemented as phase one of the reforms.
- **August 2010:** The Government announces its intention to ban unsolicited offers to increase credit card limits as phase two of the implementation.
- **September 2010 – February 2011:** Numerous consultations held with industry and consumer groups.
- **4 March 2011:** Treasury releases an exposure draft Bill for consultation.

[92] Financial Standard, *FoFA step by step,* 30 June 2014. Available at: https://www.financialstandard.com.au/media/library/FS_Documents/FS_FoFA_Step_by_Step.pdf?c3d75, http://asic.gov.au/regulatory-resources/financial-services/future-of-financial-advice-reforms/fofa-background-and-implementation/

[94] The Treasury, *Fit for the future: A capability review of the Australian Securities and Investments Commission,* December 2015. Available at: http://www.treasury.gov.au/~/media/Treasury/Publications%20and%20Media/Publications/2016/Fit%20for%20the%20future/Downloads/PDF/ASIC-Capability-Review-Final-Report.ashx. http://www.treasury.gov.au/~/media/Treasury/Publications%20and%20Media/Publications/2016/Fit%20for%20the%20future/Downloads/PDF/ASIC-Capability-Review-Final-Report.ashx.

- **24 March 2011:** Draft legislation introduced to ban unsolicited offers to increase credit card limits.
- **May 2011:** Economics Committee inquiry established.
- **July 2011:** Date of Royal Assent for credit card reforms.
- **July 2012:** Credit card reforms came into effect.

Question 29: What arrangements should apply if an ASIC intervention is subject to administrative or judicial appeal? Should an appeal extend the duration that the Government has to make an intervention permanent?

If an ASIC intervention is under administrative or judicial appeal, the intervention should remain in place until the appeal is resolved.

Question 30: What mechanism should the Government use to make interventions permanent and should the mechanism differ depending on whether it is an individual or market wide intervention? What (if any) appeal mechanisms should apply to a Government decision to make an intervention permanent?

Extensions of ASIC interventions or permanent policy changes by Government should be implemented by the Minister via legislative instrument, rather than amendment to the relevant Act. This enables the Minister to respond to concerns promptly and decisively by avoiding the delays of passing legislation through both houses of Parliament.

Question 31: Are there any other mechanisms that could be implemented to provide certainty around the use of the product intervention power?

In our view, legislation regarding the product intervention power should be principles based, with examples provided in the relevant explanatory memorandum. ASIC guidance in the form of its regulatory guides will provide certainty around the use of the product intervention power to industry and consumer groups.

Question 32: Do you agree with the powers applying from the date of Royal Assent? If not, please explain why with relevant examples.

Yes. However, we note that the Proposals Paper refers to 'prospective investments' in relation to the proposed commencement date. This may be an error. It should be clarified that the powers would apply to all products from the date of Royal Assent, not just investment products.

ENFORCEMENT AND CONSUMER REDRESS

Question 33: What enforcement arrangement should apply in relation to a breach of the design and distribution obligations or the requirements in an intervention?

The full suite of ASIC enforcement tools should be available in relation to a breach of the design and distribution obligations or the requirements in an intervention: civil, criminal, injunctive and administrative. Where ASIC only has certain tools available to it, enforcement mechanisms can be less used and effective. For example, non-compliance with breach reporting obligations attracts criminal penalties only, meaning that ASIC has a less flexible approach to ensuring compliance.

We think it is very important that ASIC has a broad and flexible tool-kit, and understand that this issue will be considered further within the context of the current ASIC Enforcement Taskforce Review.

ASIC also requires the resources and skills to effectively enforce the design and distribution obligations, and use the proposed product intervention power. We note the findings of the ASIC Capability Review, which found that ASIC required a cultural shift 'to become less reactive and more strategic and confident'.[94] We believe ASIC's ability to act proactively has not necessarily been restricted by cultural problems, but rather by restrictions on its powers and resources. Realistic long-term funding is essential. However, we agree that ASIC must be strategic and confident in its use of the proposed product intervention power. The power must be used in a pre-emptive, preventive and timely manner to protect consumers from harm.

Question 34: What consumer rights and redress avenues should apply in relation to a breach of the design and distributions obligations or the requirements of an intervention?

Consumers should have access to a broad range of redress avenues in relation to a breach of the design and distributions obligations or the requirements of an intervention. In our view, access to injunctions and compensation are particularly essential. Where consumers have purchased a product (or entered a contract) that breaches the design and distribution obligations or is the subject of an intervention, these should be refundable/voidable at the option of the consumer.

Access to these remedies should be provided via EDR and civil proceedings. Class actions could be a particularly powerful tool for consumers. In our view, allowing a consumer to seek redress for a breach of the design and distribution obligations would not amount to an individual suitability test. If a consumer, outside a properly defined target market, accessed a product despite the provider taking the required steps to avoid this occurring, then it is unlikely any claim could be made.

In relation to class actions, we acknowledge that these actions can be costly, complex and time consuming. There are also concerns about the lack of regulation in the litigation funding industry, which need to be addressed.[95] We also note that there have been examples of class actions not being conducted in the primary interests of consumers, where large legal bills significantly reduce the compensation available to class members. In this scenario, we encourage ASIC to use its powers to intervene early in the class action process when it is apparent consumers' interests are at risk. However, class actions may well be a very appropriate additional remedial process where providers have breached obligations to a target class of consumers. Class actions can also support public enforcement processes, noting that

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[94] The Treasury, *Fit for the future: A capability review of the Australian Securities and Investments Commission,* December 2015. Available at:
http://www.treasury.gov.au/~/media/Treasury/Publications%20and%20Media/Publications/2016/Fit%20for%20the%20future/Downloads/PDF/ASIC-Capability-Review-Final-Report.ashx.
http://www.treasury.gov.au/~/media/Treasury/Publications%20and%20Media/Publications/2016/Fit%20for%20the%20future/Downloads/PDF/ASIC-Capability-Review-Final-Report.ashx.

[95] The Conversation, *Regulations needed for litigation funders who can't pay out when cases fail,* 15 February 2017. Available at: http://theconversation.com/regulations-needed-for-litigation-funders-who-cant-pay-out-when-cases-fail-72502.

it is unreasonable to expect that ASIC has resources to take action in relation to every possible matter.

We also suggest that the Government consider increasing EDR caps to allow for appropriate redress for higher value claims.

As noted above, we support the extension of the design and distribution obligations and product intervention power to unlicensed financial service and credit providers. We recommend that these entities be required to be registered with an EDR scheme to ensure consumers have appropriate access to redress. Financial services and credit licensees, as well as some unlicensed financial product issuers, are already required to be registered with an EDR scheme. However, amendments to the Corporations Act (or ASIC Act) and the National Credit Act will be required to ensure other unlicensed issuers and distributors are registered.

The contributors to this submission would be pleased to discuss the issues addressed in this submission in further detail.

Please contact Senior Policy Officer Katherine Temple at Consumer Action Law Centre on 03 9670 5088 or at katherine@consumeraction.org.au if you have any questions about this submission.

Yours sincerely

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APPENDIX A: ABOUT THE CONTRIBUTORS

Australian Shareholders' Association

The Australian Shareholders Association (ASA) is an independent, not-for-profit, member-funded organisation that has grown to be the major autonomous body representing Australian retail investors. Our advocacy promotes the interests of retail shareholders. ASA also helps its members improve their investment knowledge through its educational offerings.

Care Inc Financial Counselling Service and the Consumer Law Centre of the ACT

Care Inc. Financial Counselling Service has been the main provider of financial counselling and related services for low to moderate income and vulnerable consumers in the ACT since 1983. Care's core service activities include the provision of information, counselling and advocacy for consumers experiencing problems with credit and debt. Care also has a Community Development and Education program, provides gambling financial counselling as part of the ACT Gambling Counselling and Support Service in partnership with lead agency Relationships Australia; operates outreach services in the region and at the Alexander Maconochie Centre and makes policy comment on issues of importance to its client group. Care also operates the ACT's first No Interest Loans Scheme, which was established in 1997, and hosts the Consumer Law Centre of the ACT.

CHOICE

Set up by consumers for consumers, CHOICE is the consumer advocate that provides Australians with information and advice, free from commercial bias. By mobilising Australia's largest and loudest consumer movement, CHOICE fights to hold industry and government accountable and achieve real change on the issues that matter most.

Consumer Action Law Centre

Consumer Action Law Centre is an independent, not-for-profit consumer organisation based in Melbourne. We work to advance fairness in consumer markets, particularly for disadvantaged and vulnerable consumers, through financial counselling, legal advice and representation, and policy work and campaigns. Delivering assistance services to Victorian consumers, we have a national reach through our deep expertise in consumer law and policy and direct knowledge of the consumer experience of modern markets.

Consumer Credit Legal Service (WA) Inc

Consumer Credit Legal Service (WA) Inc. (CCLSWA) is a not-for-profit charitable organisation which provides legal advice and representation to consumers in WA in the areas of credit, banking and finance, and consumer law. CCLSWA also takes an active role in community legal education, law reform and policy issues affecting consumers. In the 2015 / 2016 financial year, CCLSWA provided comprehensive legal advice to 1350 clients on 1424 matters.

Consumers' Federation of Australia

The Consumers' Federation of Australia is the peak body for consumer organisations in Australia. CFA represents a diverse range of consumer organisations, including most major national consumer organisations. Our organisational members and their members represent or provide services to millions of Australian consumers.

COTA Australia

COTA Australia is the national consumer peak body for older Australians. Its members are the State and Territory COTAs (Councils on the Ageing) in each of the eight States and Territories of Australia. The State and Territory COTAs have around 30,000 individual members and more than 1,000 seniors' organisation members, which jointly represent over 500,000 older Australians.

COTA Australia's focus is on national policy issues from the perspective of older people as citizens and consumers and we seek to promote, improve and protect the circumstances and wellbeing of older people in Australia. Information about, and the views of, our constituents and members are gathered through a wide variety of consultative and engagement mechanisms and processes.

Financial Counselling Australia

FCA is the peak body for financial counsellors. Financial counsellors provide information, support and advocacy for people in financial difficulty. They work in not-for-profit community organisations and their services are free, independent and confidential. FCA is the national voice for the financial counselling profession, providing resources and support for financial counsellors and advocating for people who are financially vulnerable.

Financial Rights Legal Centre

Financial Rights is a community legal centre that specialises in helping consumers understand and enforce their financial rights, especially low income and otherwise marginalised or vulnerable consumers. We provide free and independent financial counselling, legal advice and representation to individuals about a broad range of financial issues. Financial Rights operates the Credit & Debt Hotline, which helps NSW consumers experiencing financial difficulties. We also operate the Insurance Law Service which provides advice nationally to consumers about insurance claims and debts to insurance companies. Financial Rights took over 25,000 calls for advice or assistance during the 2014/2015 financial year.

Professor Gail Pearson – The University of Sydney Business School

Professor Gail Pearson (BA (Hons), PHD, LLB) is a leading academic in the fields of financial services, commercial and consumer laws. She is the author of Pearson, G *Financial Services Law and Compliance* Cambridge University Press 2009, Pearson, Fisher and Ali *Commercial Law: Commentary and Materials* (ed2) Lawbook 2004, the major Australian text in this area and also of *Consumer Protection Law*, ed 5 Federation 1998 (with Goldring, Maher and McKeough). She has published numerous articles in Australian and international journals including a pieces on risk, self-regulation and innovation in financial services.