NORTON ROSE FULBRIGHT

# Regulatory regimes guide: Design and distribution obligations

March 2021

## Snapshot

### At a glance...

#### What?

A new design and distribution regime requiring issuers and distributors of financial products to place retail consumers at the centre of their product governance arrangements to ensure products are designed for an identifiable and appropriate target market and are distributed using suitable channels and methods to reach that target market. Significant civil and criminal penalties apply to breaches of the new obligations.

#### Who is impacted?

Issuers and distributers of most retail financial products, including banks, credit providers, superannuation trustees, insurers, investment managers, fund managers and many fintechs.

#### When?

5 October 2021.

### Considerations

#### Setting the standard for TMDs

The target market determination is the cornerstone of the regime. It must contain prescribed information about the intended retail consumers, the distribution conditions, the review triggers and the information distributors must provide to issuers.

Issuers can't afford to get this step wrong although unfortunately, there's no definition of 'target market,' no TMD template set by ASIC and only limited guidance on how much detail must be included. Setting clear expectations about the level of analysis required to support a TMD, coupled with clear guidance on the expected content and a robust verification/approval process, will be critical to drive consistent and quality TMDs across business and product lines.

#### Implications for accountabilities

Any changes implemented to the current product governance arrangements to align with the DDO regime must be considered in the context of BEAR (and in the future, FAR) accountabilities. ADIs must already designate an accountable person for end-to-end product responsibility so it will be essential to map accountability for any new obligations that come into effect from October 2021.

The overarching governance and reporting regimes will also need to reviewed, refreshed and reset. The stakeholders and capabilities that need to be represented in the product governance working group will be an important consideration.

#### Magnified complaints and disputes risk

Past and present TMDs must be available publicly free of charge. While the transparency is a positive development, it's likely that the availability of this information will increase the volume of complaints, as well as the number of civil proceedings and class actions.

Organisations should carefully consider how to mitigate these risks but also how to upskill their relevant teams to appropriately deal with complaints and disputes alleging breaches of the DDO regime. These teams should be reflecting on the need to review TMDs and proactively address inconsistencies in product-related complaints and disputes.

#### Interconnected regulatory reform

One of the key risks and challenges facing the industry is the degree of overlap between each of the new regulatory regimes coming into effect in October 2021.

For example, product-related complaints may indicate that the distribution conditions are not working effectively and trigger immediate obligations to review the appropriateness of the TMD and cease distribution. The findings from that appropriateness review could identify a significant breach of the DDO regime which is reportable to ASIC under the new breach reporting regime.

# Design and Distribution Obligations – What's new?

## Overview

ASIC has released its long-awaited Regulatory Guide 274: Product design and distribution obligations (**DDO**). At over 80 pages long, there is a lot of detailed guidance to digest and much has changed since the draft regulatory guide was released more than a year ago.

The DDO regime will commence on 5 October 2021 (following a six-month COVID-19 driven extension) and represents the most significant regulatory change that will occur in a transformative year ahead for the financial services industry.

Nearly every part of the financial services industry will be impacted and the implementation of an effective product governance framework across the life cycle of retail products is now an immediate priority given the work entailed.

| Design obligations (for issuers) | Distribution obligations (for distributers save where indicated) |
|---|---|
| Prepare a TMD which is publicly available | Don't distribute a product where no TMD |
| Review the TMD as required for appropriateness | Don't distribute a product where TMD may no longer be appropriate |
| Keep decision making records | Take reasonable steps so that distribution consistent with TMD (issuers and distributers) |
| Notify ASIC of significant dealing | Collate, keep and share distribution information |
| | Notify issuer of significant dealing |

### Purpose

The regime is designed to help consumers obtain suitable products to improve outcomes. The DDO regime firmly places consumers at the heart of product governance by requiring issuers to design financial products that meet the objectives, financial situation and needs (together, **Needs**) of the intended class of retail consumers, known as the target market.

Issuers and distributors will also be required to take reasonable steps to ensure financial products are distributed to the target market through appropriate distribution channels.

For many in the industry, the DDO will require a fundamental shift in how products are designed, marketed, distributed and monitored. The imperative of putting the consumer at the centre of product governance and decision making should not be overshadowed by a box-ticking compliance approach.

### Coverage

Most financial products issued to retail clients are covered by the regime, including life insurance, superannuation, credit contracts (e.g. home loans, credit cards), basic banking products, investment platforms and investment management products. Notable exclusions include MySuper products, margin lending facilities, most ordinary shares, products issued to wholesale clients and credit provided for business purposes (although there is no guidance on how a 'business purpose' should be determined).

It applies broadly to issuers and distributors of financial products. Issuers are broadly anyone who issues in-scope financial products to retail consumers. This includes those who must prepare a prospectus or product disclosure statement (**PDS**) under the Corporations Act, anyone who issues in-scope credit products and anyone prescribed by regulation.

Distributors are broadly any regulated persons who distribute in-scope products to retail consumers. Distributors will be caught by the regime if they engage in 'retail product distribution conduct' which means that they either deal in a product, provide a prospectus or PDS for a product or provide financial product advice which is general in nature.

### Target Market Determination

The TMD is the cornerstone and impacts every part of the new regime so it's essential to get this step right. Crucially, it must clearly describe an identifiable class of retail consumers who comprise an *appropriate* target market for the financial product.

To discharge this obligation, issuers will need a deep understanding of how key product features can and will meet the Needs of the target market. This should be backed up by stress testing, scenario analysis and extensive data analysis which evaluates how the product will perform in the hands of the consumer and the outcomes it will achieve.

The TMD must also specify conditions and restrictions on distribution and explain why they will make it more likely that the product will reach the target market. This will require careful consideration and analysis of how the distribution strategy (e.g. channels, marketing, choice architecture and sales practices) impact consumers and their buying behaviours. There are a number of other prescriptive requirements that the TMD must satisfy to be valid and organisations should give careful thought to how they can ensure TMDs meet these requirements consistently across different business and product lines.

### Continuous monitoring

The appropriateness of a TMD must be reviewed by the issuer periodically and on the occurrence of a review trigger or other event or circumstance.  Review triggers must be specified in the TMD and are events or circumstances that could reasonably suggest that the product is not consistent with the Needs of the target market and/or the distribution conditions are not working effectively.

What constitutes a review trigger will vary from product to product depending on its nature and the circumstances surrounding its issue – organisations should avoid a 'one size fits all' approach. Issuers should consider all data available when setting the review triggers and undertaking product reviews, including consumer, performance, product, value and transaction data. If the product is new, analogous product data should be used as a proxy where available.

Where an issuer knows (or ought to know) that a TMD may not be appropriate, within 10 business days, it must stop issuing the product and direct its distributors to stop distributing the product until the TMD has been reviewed and appropriate steps have been taken.

### Reasonable steps

Issuers and distributors must take reasonable steps aimed at reducing the risk of the product being distributed outside the target market, or inconsistently with the TMD. Issuers will need to consider all of the circumstances of the product's distribution, including the channels, choice architecture, sales practices and marketing, and use this information to specify objectively clear distribution conditions in the TMD. Extensive distributor due diligence and adequate monitoring and supervision of product distribution will also be important.

For distributors, ASIC has indicated that adherence to distribution conditions alone will generally not be enough to meet the reasonable steps obligation. Instead, distributors will be expected to proactively consider and review the route to market and their interactions with consumers and put arrangements in place that will facilitate distribution that is consistent with the TMD.

### Information sharing

The importance of comprehensive, transparent and prompt communications between issuers and distributors cannot be understated. Not only will the TMD specify what information distributors must provide to issuers to assist with periodic and triggered reviews but the parties will need to establish a clear framework for the flow of information regarding significant dealings, stop distribution notifications and ad hoc feedback amongst other things.

How this information is collated, shared and acted on will be critical from a compliance perspective and current distribution agreements should be revisited and renegotiated where necessary to facilitate this.  Steps are being taken at an industry level and also among data transmission service providers to provide solutions as to how the relevant data can be captured, aggregated and exchanged. Issuers and distributors would be well advised to keep up to date with these IT solutions as and when they come to market.

## Significant dealings

Distributors must notify issuers of significant dealings in products that are inconsistent with the TMD as soon as possible, and within 10 business days. A similar obligation is placed on issuers, albeit the notification must be given to ASIC rather than a distributor.

There is no definition of significant dealing – it is a matter to be determined by the parties depending on the circumstances of each case – but factors that ASIC expect will be taken into account include the number of consumers who have acquired the product outside the TMD, the complexity of the product and the potential harm that may be caused to impacted consumers.

Notification of a significant dealing amounts to a review trigger that will require issuers to review the appropriateness of the TMD within 10 business days. If distributors set the significant dealing threshold too low, issuers may find themselves in an almost continual cycle of TMD review which will be both time consuming and disruptive for distribution channels.

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