Law Council
OF AUSTRALIA
Business Law Section

13 February 2018

Manager
Financial Services Unit, Financial System Division
The Treasury
Langton Crescent
Parkes ACT 2600

By email: ruth.moore@treasury.gov.au

Dear Sir/Madam

Re: Submission on Treasury Laws Amendment (Design and Distribution Obligations and Product Intervention Powers) Bill 2017

We refer to the Exposure Draft for the Treasury Laws Amendment (Design and Distribution Obligations and Product Intervention Powers) Bill 2018 (**Exposure Draft**) and the accompanying Explanatory Memorandum which has been released for public comment.

The Corporations Committee (**CC**) of the Business Law Section of the Law Council welcomes the opportunity to provide a submission in relation to the Exposure Draft and is appreciative of the opportunity to be involved in the consultation process.

1 Key issues of principle - observations

We observe that while the CC is supportive of Government's commitment to stronger consumer protection in cases of mis-selling or exploitation of vulnerable consumer groups, we remain concerned that the introduction of the design and distribution obligations and product intervention power, as formulated in the Exposure Draft, will:

- increase moral hazard on the part of consumers;
- deprive issuers of legitimate benefit of properly prepared disclosure and due diligence, and undermine the basis of disclosure regulation;
- unduly increase the costs and burden on existing businesses in a way that is disproportionate to the benefit of the intended consumer outcomes (and in some cases frustrates consumer outcomes);
- stifle legitimate product innovation;

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- result in the withdrawal of beneficial products and services from retail investors;
- frustrate existing Government initiatives to stimulate a corporate bond market; and
- deter foreign companies from listing on Australian markets.

We are also concerned that the formulation of the Exposure Draft currently has some points of ambiguity and creates some unintended consequences, and remain of the view (raised in prior consultation) that there is a need for greater checks and balances on the use of the intervention power.

We would encourage Treasury to commit to industry consultation and review of the exercise of these new powers, within a period of 2 years following their introduction.

2 Particular comments – design and distribution obligations

2.1 Scope of products covered

(a) Ordinary Shares – flaws in the framework

The carve out for Ordinary Shares will be rendered ineffective for a large proportion of existing listed companies. This is because it is common for listed company constitutions to contain provisions permitting ordinary shares to be converted to preference shares.

Section 993DB(3)(a) (the preference share provision) in the Exposure Draft is misconceived, and goes far beyond what is appropriate as an anti-avoidance mechanism.

We recommend that section 993DB(3) should be deleted and an anti-avoidance clause should be cast so that it only responds in the limited circumstances in which there is a clear purpose of avoidance.

(b) No carve-out for foreign ordinary shares

The carve-out for ordinary shares in a company does not extend to foreign companies - whether listed on Australian stock exchanges (whether directly, or via the listing of depositary interests) or otherwise.

This creates an undue burden on fundraising by foreign companies, and a disincentive for foreign companies to remain listed in Australia or to offer securities under disclosure documents or recognised offers in Australia. It appears to be inconsistent with the policy behind mutual recognition. There does not appear to be any policy justification for the distinction.

We recommend that the carve-out should extend to foreign ordinary shares, and depositary interests in those shares.

(c) No carve-out for listed stapled securities and units in listed trusts that are similar to shares

Treasury has indicated the rationale (of demarcation difficulties) for not carving out listed stapled securities and units in listed trusts, notwithstanding that those products may have more in common with shares than structured products. However, the impediment to fundraising and potential cost burden that this creates is of concern. This is particularly the case in infrastructure funds, an area where governments rely on the aggregation of private capital to fund large, long-term projects which benefit communities.

We recommend that the Explanatory Memorandum should make it clear that it is intended that these entities should have a reasonable expectation that case-by-case relief will be readily available from ASIC.

(d) Simple Corporate Bonds – specific, government-driven retail market initiative

Simple Corporate Bonds were developed by Government over the course of several years to address an identified need in Australian retail markets.

These are senior bonds with prescribed terms that ensure that they do not have complex terms or discretions. These were specifically developed to try to reduce the regulatory burden of retail bond issuance, to encourage the development of a retail bond market.

The objective was to reduce the difference in terms of cost and process for issuing retail bonds compared to issuing wholesale bonds – which had operated as significant impediments to the development of this market.

This objective will be defeated if these products are not carved-out.

We recommend that a carve-out be added. This is not a matter that is suitable for case-by-case relief, which also adds to cost for each issue.

(e) Pass-through products – specific concerns

There are certain products in the Australian market which have been specifically designed, with regulatory support, to provide diversification to Australian retail investors for reduced cost of investment in seasoned underlying products. In particular:

- XTBs – an ASX listed unit trust that provides pass-through interests in separate seasoned wholesale bonds on an unsponsored basis (i.e. the issuer of the bond is not involved – this is secondary trading in the underlying bond), with regulated product disclosure. The policy objective behind the regulatory relief that supports this product was to support retail investor access to seasoned bonds, again to provide retail access to yield products that are not hybrid securities, without imposing undue costs.
- TraCRs – Chi-X quoted, unsponsored depositary receipts providing a one-for-one beneficial interests in existing US listed shares in the S&P500, with FX conversion into $A, which should provide significantly cheaper access for retail investors to US listed shares compared to current international retail broking and FX rates.

If these pass-through products are not carved-out, this will frustrate the policy objective of these various reforms and initiatives, that have been regarded as beneficial products to extend to retail investors.

In each case, the fees charged on these products are minimal and the inclusion of these in the regime would create a burden of added cost and process for the issuers that may be prohibitive.

In each case, the products have no involvement of the underlying security issuer (i.e. unsponsored), and different forms of regulatory relief from disclosure on the underlying products has been granted.

We recommend that these products should be carved out, or specific regulatory relief readily granted. If a complete carve out is not available – we note that:

- It is a disproportionate burden to require Target Market analysis to be done on the underlying securities, and this should be carved-out. This is particularly the case for products where the underlying securities can be directly purchased by retail investors; and

- Where there is a process for continuous issuance as a liquidity mechanism for the listing market, this is closely akin to secondary trading and should be carved-out.

(f) No carve-out for rights issues and mergers

In some circumstances, a rights issue or a merger by a listed entity will require a prospectus and/or product disclosure statement, and will be affected by the regime – but there is an obligation to extend the rights issue or merger terms to all stakeholders, and therefore it is inappropriate to require a target market determination.

For instance:

- where an ASX-listed stapled entity, trust or foreign company needs to conduct a rights issue to raise capital but has been suspended from trading for more than 5 days. The rights issue must be offered to all stakeholders in Australia and New Zealand;
- where a stapled entity, trust or foreign company makes a merger proposal to an Australian target (or to a foreign target with Australian stakeholders) in circumstances which require a prospectus and/or product disclosure statement. The merger proposal must be offered to all stakeholders of the target.

We recommend that there should be a carve-out for rights issues and merger or takeover proposals, or other offers which must be made with a disclosure document to the existing stakeholders of an Australian entity.

2.2 Exclusion of secondary trading on listed markets

We understand that the intention of the Exposure Draft is to exclude secondary trading on listed markets. In our view the draft does not clearly achieve that objective in all circumstances, and the test for when a dealing amounts to secondary trading is too complicated.

For instance, in our view there is potential for secondary trading to be caught in scenarios of controller sales, but there does not appear to be any policy basis for this.

In addition, for investors in listed products, it is not practicable for them to assess whether their products are caught by the regime or not. In our view this impacts the efficiency and integrity of trading on Australian stock exchanges and should be addressed.

We recommend that there should be a clear and comprehensive statement of exclusion of secondary trading on recognised exchanges. Any concerns regarding avoidance should be dealt with in an anti-avoidance provision which clearly references a purpose of avoidance.

2.3 Concerns regarding Target Market Determinations

(a) Liability concerns

Negligence standard versus absolute liability irrespective of fault

The design and distribution obligation regime has drawn on regimes applicable in the United Kingdom and Europe for its content. However, Australia's disclosure liability regime is different, and more onerous, than those applicable in those various jurisdictions. In particular, this is due to section 1041H of the Corporations Act, which imposes liability irrespective of knowledge, intention or other fault on the part of the person engaging in the conduct.

While the Target Market Determination has been proposed as a "negligence" standard of liability for issuers, through its formulation as a failure to "take reasonable steps", the obligation to make the Target Market Determination public creates the risk of innocent misstatement liability (under section 1041H), which is a heavier burden of liability. If a Target Market Determination is to be published at all (see further comments below), it should have the benefit of due diligence defences and reasonable reliance defences consistent with the content of the prospectus or product disclosure statement for the accompanying issue of securities or financial products.

We recommend that disclosure of the Target Market Determination should have the benefit of these defences to be consistent with the intended "negligence" standard of liability.

Litigation strategies by professional litigants (litigation funders and class action firms)

In addition, we have concerns that the new regime will be capable of use beyond its intended purpose by professional litigants, to create expanded liability for those involved making Target Market Determinations.

For instance – where issuers are not professional financial product manufacturers (most listed entities), they will be unlikely to have the skillsets or information necessary to form a Target Market Determination and will be reliant on advice from third parties with market and distribution experience or insight. For those third parties, involvement in making a Target Market Determination can attract involvement or accessory liability. In other securities class actions – professional litigants have sought to expand the liability of advisers, intermediaries and experts of this kind, by pleading that they are not only liable for the content of their advice or report, but claiming consequential loss relating to the entire offer. Even where claims appear far-fetched, settlements are reached because of the costs of the litigation.

This is already a concern for advisers, intermediaries and experts, but in this case, we are concerned that it may limit the availability of advice to issuers to support Target Market Determinations.

We recommend that, consideration be given to means of striking a more reasonable balance of liability (aligned to culpability), including consideration of whether regulatory sanctions should be sufficient without opening this up to “private” remedies.

Self-reporting obligation on non-AFSL holders

In the same vein as the comments above, we have some concerns about the inclusion of self-reporting obligations under section 993DD(3). In the case of AFSL holders, this would appear to be an unnecessary duplication; in the case of non-AFSL holders (for instance, those issuers who are not in the business of manufacturing financial products), we are concerned about the imposition of this sort of obligation.

The obligation to report a breach does not have any sort of materiality threshold – in contrast (at least currently) to self-reporting for AFSL holders – and it could be contravened unknowingly. In addition, we are concerned about this sort of obligation connecting to civil penalty provision sanctions, when a contravention can be innocent or accidental.

We recommend that, as noted above, consideration be given to means of striking a more reasonable balance of liability (aligned to culpability). We question whether contraventions of this kind should be capable of giving rise to compensation orders.

Guidance (non-exhaustive) around reasonable steps

In our view greater guidance is needed around what may constitute reasonable steps, and consideration should be given to adoption of a reasonable reliance defence (in parallel to disclosure liability for disclosure documents).

For instance, it should be clear that an issuer who is not a professional product manufacturer (or where the financial product being issued is not part of their business – e.g. hybrid securities issued by insurance companies), is entitled to seek competent third party advice to assist it to make a Target Market Determination, and that it may reasonably rely upon that advice.

This does not enable an issuer to wilfully ignore obvious defects in the advice, as it is well established that reliance on the advice in those circumstances would not be reasonable.

We recommend that a reasonable reliance defence, or failing that, clear guidance in the Explanatory Memorandum to indicate that reasonable reliance on competent third party advice is one means of satisfying the reasonable steps obligation.

(b) Publication of Target Market Determination as a positive assertion of suitability

While we acknowledge that Target Market Determinations are not intended to be so granular that they represent personal financial product advice, we consider that there remains scope for confusion as to their meaning.

In part this is because the language echoes the wording used in the definition of personal advice, and in the mandatory general advice warning (see sections 766B(3) and 949A).

There is also a significant risk that investors view target market determinations as a positive warranty of suitability. This raises the liability concerns noted above, but also raises a moral hazard that consumers simply assume that a product meets their particular needs because they can access it. In our view, this may increase the risk to retail investors rather than reducing it.

We recommend that the legislation clarify that the Target Market Determination is not a positive statement of suitability or recommendation that an investor may rely upon in making an investment decision, and it does not supplant an investor's obligation to take appropriate advice and make their own assessment of their investment decision in light of their own needs, objectives and circumstances.

(c) Guidance around market analysis

It is not practicable for the securities market and distribution channels to respond to a wide variety of bespoke determinations, as brokers and other distribution intermediaries need to know what sort of information they must gather about their clientele.

We expect that some standardised frameworks will emerge shortly after implementation of the new regime, and anecdotal evidence from the United Kingdom and Europe suggests that this is starting to occur in that market.

We recommend that, to reduce disproportionate cost and burden upon industry, and to provide some safeguards as to quality of analysis, Treasury and ASIC should actively engage with peak industry bodies to assist the development of standardised frameworks and nomenclature. This may also assist to establish frameworks that are not so granular as to cross the line into personal advice.

(d) Personal advice definition

There appears to us to be a risk that issuers and distributors will be concerned that making enquiries of prospective investors, in order to meet their product suitability obligations, may cross a line of being seen to provide personal advice.

This is problematic from a number of perspectives, including the:

- need to properly managing investor expectations, and not create an expectation that the issuer or distributor is assessing suitability at a personal level; and
- issuer or distributor may not be licensed to provide personal advice, and needs to be able to set clear protocols to ensure compliance with licence conditions or avoid a contravention.

We recommend that section 766B(3) be amended (or a regulation made under section 766B(9)) to make it clear that enquiries about a person's objectives, financial situations or needs for the purposes of complying with section 993DE are excluded from the definition of personal advice. This is the approach taken in section 766B(3) to compliance enquiries for the purposes of the Anti-Money Laundering and Counter-Terrorism Financing Act 2006. In addition, it should be made clear that it is possible to use the general advice warning in section 949A, notwithstanding having made these enquiries.

3 Product Intervention Order powers

3.1 General concerns around use of this power

As noted in earlier rounds of consultation, a concern remains that investors will apply pressure to Government and regulators to use this power to change the commercial terms of an investment simply because it has ceased to suit them, and notwithstanding they understood it quite clearly when they entered into it.

This would be particularly unfair to issuers in circumstances where care has been taken over disclosure and Target Market Determinations, and there has been no misleading disclosure, clear mis-selling or other breach of law.

We have understood, in discussions with Treasury, that the power is not intended to be capable of use in this way – but we cannot ascertain how the Exposure Draft would prevent it. One comment was that it could not be used to affect retrospective outcomes, only future rights – but in our view that constraint would not be sufficient to avoid the moral hazard that retail investors assume that Government or regulators will intervene if a product ceases to be advantageous to them at some future time.

We recommend that, if the policy is that usage in this way is not intended, that must be made clear in the legislation or, at the very least, in the Explanatory Memorandum.

3.2 Interim orders by ASIC

We note that section 993DI(5) allows ASIC to make an interim order without holding a hearing.

While we accept the practical need for interim measures, in our view, for ASIC to make an interim order it must be able to identify reasonable grounds for doing so as a minimum standard to warrant intervention.

This is consistent, for example, with infringement notice processes where ASIC is proceeding merely upon an allegation of a contravention, rather than one which has been established.

We recommend that the legislation should require the power to be exercised on reasonable grounds.

3.3 Failure by ASIC to follow due process

We note that section 1022CE of the Exposure Draft requires ASIC to conduct consultation before making an order, but the failure to do so has no effect on the validity of the order. This lack of accountability for a failure to follow due process is not an acceptable regulatory standard.

We recommend that if the prescribed process is not followed, the process should be recommenced and the order revoked until it is completed properly.

3.4 Publication of orders without private consultation

Section 1022CE enables ASIC to conduct consultation by public publication of a proposed order. This may have highly adverse consequences for existing issuers whose products are affected.

We recommend that private consultation should be conducted with issuers who are clearly affected, before public consultation is commenced.

4 Checks and balances

We remain generally concerned that the checks and balances on these significant new obligations and powers are insufficient and not practically accessible to issuers and distributors, and it is difficult to ascertain the nature and extent of the impact that they will have on the Australian capital markets.

We recommend that a comprehensive review of the use and impacts of these new obligations and powers be conducted within 2 years following their commencement, and that Treasury and ASIC monitor comments from industry throughout that period.

If you wish to discuss any of these submissions in more detail – please do not hesitate to contact: Shannon Finch, King & Wood Mallesons at Shannon.finch@ay.kwm.com.

Yours sincerely

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