Design and distribution obligations: Investment products

Report 762 | May 2023

About this report

In 2022, ASIC reviewed compliance with the design and distribution obligations by issuers of investment products (i.e. interests in managed investment schemes, shares issued by an investment company, preference shares and debentures). This report summarises our key observations on how issuers of investment products are meeting these obligations and highlights areas for improvement.

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Executive summary

The design and distribution obligations commenced in October 2021. These obligations are intended to help consumers obtain appropriate financial products by requiring issuers and distributors to have a consumer-centric approach to the design and distribution of products.

In particular, these obligations require:

- issuers to prepare a target market determination (TMD), comprising a target market reflecting a class of consumers whose likely objectives, financial situation and needs are met by the product
- issuers and distributors to take 'reasonable steps' that are reasonably likely to result in financial products reaching consumers in the target market defined by the issuer, and
- issuers to monitor consumer outcomes and review products to ensure that consumers are receiving products that are likely to be consistent with their likely objectives, financial situation and needs.

ASIC recently conducted an initial review of compliance with the design and distribution obligations by issuers of investment products. The types of investment products we looked at included interests in managed investment schemes, shares issued by an investment company, preference shares and debentures. We focused on investment products because we were concerned that consumers risked being inappropriately exposed to high-risk products.

Our review found that there is considerable room for improvement.

We have set out the findings from our initial review to provide product issuers with practical observations about the product design and approval process, TMDs and meeting the reasonable steps obligation and review obligations.

As a result of our initial review, ASIC issued 26 interim stop orders for breaches of the TMD requirements by issuers of investment products. As a result of our action, 12 issuers amended 18 TMDs and five issuers withdrew seven TMDs.

We took action against a range of product issuers—from issuers that offer niche products through to those that offer traditional investment products.

Our findings at glance include the following:

- **Defining a target market too broadly** was a factor in 15 stop orders. For example, an issuer described a product that generated no to very little income distribution as being potentially appropriate for a consumer seeking income. ASIC's intervention resulted in the issuer amending the target market so consumers seeking income were excluded.
- **Inappropriate risk profiles being used in the target market** was a factor in 21 stop orders. For example, a high-risk product was considered to be appropriate for consumers with a medium risk tolerance. ASIC's intervention resulted in the issuer amending the target market to exclude consumers with a medium risk tolerance.
- **Including inappropriate levels of portfolio allocation in a target market** was a factor in 10 stop orders. For example, an issuer recommended an investible asset allocation of up to 75% for a single, high-risk product. ASIC's intervention resulted in the issuer amending the asset allocation down to 25%.
- **Inappropriate intended investment timeframe and/or withdrawal needs in the target market** was a factor in 18 stop orders. For example, an issuer stated that consumers requiring 'annual or longer' withdrawal rights were in the target market despite the product not having any withdrawal rights before the end of the fixed term. ASIC's intervention resulted in the issuer amending the target market so that those consumers who needed the right to withdraw money before the end of the fixed term of the product were outside the target market.
- **Inappropriate or no distribution conditions** was a factor in 13 stop orders. For example, an issuer with a very narrow target market did not include any distribution conditions. ASIC's intervention resulted in the issuer including distribution conditions.
- **Inappropriate use of a TMD template** was a factor in 13 stop orders. For example, an issuer inappropriately relied on a pre-set asset allocation in a template of up to 25% for a single asset. ASIC's intervention resulted in the issuer proposing to adjust the asset allocation to 5% before ultimately withdrawing the product.

In addition to looking at TMDs, we reviewed the product design arrangements of several issuers of managed investment schemes, and their compliance with the reasonable steps and review obligations.

Our observations are as follows:

- The majority of issuers we reviewed used a TMD template. While a template may be useful as a starting point, issuers must always consider the individual features and risks of a product and appropriately tailor the template, to ensure the target market reflects a suitable group of consumers for a product. Of ASIC's interim stop order actions to date, 13 have been in relation to the inappropriate use of a template.
- Many issuers have implemented practices to assist them in meeting the reasonable steps obligation (e.g. conducting appropriate due diligence on third party distributors and putting in place supervisory

arrangements to provide oversight of compliance with the obligation). The use of investor questionnaires to meet this obligation is prolific. Investor questionnaires alone are insufficient and must be supported by a broader governance and distribution framework.

- All issuers had arrangements for meeting their review obligations, but issuers could improve on their use of review triggers and the process undertaken to conduct a review.

The design and distribution obligations will remain a key focus for ASIC. To date, we have undertaken, or are undertaking, surveillances in relation to the small amount credit, buy now pay later, credit cards, superannuation, derivatives and investment products sectors.

We have also:

- issued a stop order in relation to credit and derivatives
- caused 9 issuers to withdraw 11 products from the market
- released surveillance findings in relation to superannuation and small amount credit contracts, and
- commenced civil penalty proceedings for alleged breaches of the design and distribution obligations against Firstmac Limited, a distributor of a managed investment scheme, and American Express Australia Limited, an issuer of a credit product.

Note: See Media Release (22-236MR) *Super trustees urged to improve effectiveness of target market determinations* (29 August 2022) and Report 754 *Target market determinations for small amount credit contracts* (REP 754).

We will continue to monitor compliance and we will take regulatory action for breaches of the obligations across our entire regulated population.

Complying with the design and distribution obligations

Purpose and scope of our review

We undertook a review that focused on compliance with the design and distribution obligations by issuers of investment products to:

- determine if the obligations have been complied with, and
- prevent poor sale and distribution practices and promote greater consumer protection by taking regulatory action where necessary.

For issuers of investment products, we reviewed the appropriateness of their TMDs, considering the risk, performance and other attributes of the products.

In addition, for issuers of managed investment schemes, we reviewed:

- the approach taken by issuers to product design, including the process they undertook to prepare a TMD
- the adequacy of distribution arrangements, including whether issuers are complying with the reasonable steps obligation, and
- issuers' review and monitoring arrangements.

In reviewing compliance, we took into account the principles-based guidance in Regulatory Guide 274 *Product design and distribution obligations* (RG 274), which details ASIC's interpretation of the obligations and sets out guidance on developing product governance, distribution and review arrangements to meet the obligations.

Note: For a summary of the design and distribution obligations, see Appendix 1. For an overview of the methodology of our review, see Appendix 2.

Regulatory action taken against poor conduct

As at the date of this report, we have placed interim stop orders on 26 investment products, of which 19 were managed investment schemes and 7 were other investment products. In 22 of these cases, the stop order was revoked after a revised TMD was provided to ASIC. Five issuers of investment products withdrew their products after ASIC's action.

In some instances, after ASIC intervention, there were significant improvements to TMDs for investment products without a stop order where the offer for the product was not open for investment, for example, due to an exposure period under s727(3) of the *Corporations Act 2001* (Corporations Act).

Outside our review, ASIC has also commenced civil penalty proceedings for alleged breaches of the design and distribution obligations against:

- Firstmac Limited, a distributor of a managed investment scheme, and
- American Express Australia Limited, an issuer of a credit product.

Note: See Media Release (22-361MR) *ASIC takes further civil penalty action for breaches of design and distribution obligations* (16 December 2022) and Media Release (22-338MR) *ASIC takes civil penalty action against American Express Australia in first court case alleging breaches of design and distribution obligations* (6 December 2022).

We will continue to take regulatory action where warranted, including where there is a high risk of consumer harm arising from non-compliance with the obligations.

Key observations: Product design

The design and distribution obligations are intended to put the consumer at the centre of the product design process. In this section, we note our observations on the product design and TMD development process of the 12 issuers of managed investment schemes we reviewed.

Consumer-centric product design

For new products, the product design process generally involves:

- identifying a class of suitable consumers for a product, which drives the design of the product
- analysing expected distribution methods to determine whether they will likely lead to distribution in line with the target market
- robust testing of the product, and
- determining monitoring and review arrangements for when the product is being distributed: see RG 274.42.

Some of the issuers of managed investments schemes we reviewed adopted the following good practices:

- **Process oversight** – Most issuers involved key senior staff in their product and TMD development process, with ultimate oversight and sign-off by the board. This practice may help issuers develop a better TMD.
- **Product testing** – Some issuers performed 'stress tests' on a scheme. This can potentially help issuers appreciate a fuller range of a scheme's potential outcomes under both average market conditions and market stress: see RG 274.90. Testing may be informative, although testing outcomes should be continually monitored and validated.
- **Distributor engagement** – Most issuers actively engaged their distributors during the product design and TMD development process. Distributors may provide helpful feedback that can help set a scheme's overall distribution strategy. However, issuers should be mindful of any potential conflicts in relying on views from distributors.

Areas for improvement

We identified the following areas for improvement among the issuers of managed investment schemes we reviewed:

- **Over-reliance on TMD templates results in a 'cookie-cutter' approach** – Some issuers relied on a TMD template to drive the process of determining an appropriate target market for a scheme. A template may be useful as a starting point, if used properly. However, in all cases, issuers still need to critically assess a product: see Use of templates to prepare TMDs.
- **Not designing products with consumers in mind** – We identified products with niche or unusual features where issuers had not given enough attention to designing the product with consumers in mind.
- **Scheme features not assessed on an 'absolute' basis** – Some issuers developed their TMD by assessing a scheme's features relative to peers or a benchmark (e.g. a scheme exposed to listed equities is more likely to provide capital preservation than its benchmark, even if both the benchmark and the scheme are not consistent with a capital preservation objective). The TMD for each scheme should be assessed on its own merits, rather than in comparison with other products or against a benchmark.

Key observations: Appropriateness of a TMD

Under the design and distribution obligations, an issuer must prepare a TMD that meets the requirements in s994B (i.e. the 'content' and 'appropriateness' requirements). To arrive at an appropriate target market, the issuer must closely consider the consumers whose likely objectives, financial situation and needs are likely to be met by a product. Appropriate distribution conditions in the TMD must make it likely for consumers who acquire a product to be in the target market.

In this section, we note some observations on the appropriateness of TMDs we reviewed. These are principally drawn from stop order actions that we have taken to date against issuers of investment products.

TMD stop orders at a glance

In the 26 stop order actions that we have taken against issuers of investment products, the following concerns were identified (many of these stop orders reflected multiple concerns):

- **Not clearly defining a target market** was a factor in 15 stop orders.
- **Inappropriate risk profiles being used in the target market** was a factor in 21 stop orders.
- **Including inappropriate levels of portfolio allocation in a target market** was a factor in 10 stop orders.
- **Inappropriate intended investment timeframe and/or withdrawal needs in the target market** was a factor in 18 stop orders.
- **Inappropriate or no distribution conditions** was a factor in 13 stop orders.
- **Inappropriate use of a TMD template** was a factor in 13 stop orders.

TMDs that do not clearly define a target market

To arrive at an appropriate target market, all issuers must closely consider the consumers whose likely objectives, financial situation and needs are likely to be met by the product. Issuers should describe a target market using objective parameters and sufficient granularity, and by critically assessing the product: see RG 274.80–RG 274.86.

Areas for improvement

Target markets that were not clearly defined was a factor in 15 of the 26 stop order actions taken against issuers of investment products to date.

Issuers should avoid 'sitting on the fence' – Issuers should ensure that their target markets are defined unambiguously. We found that the use of qualified language can be problematic. For example, the Financial Services Council (FSC) TMD template for investment products includes options for certain types of consumers to be 'potentially' included in the target market. 'Potentially' including consumers in the target market can lead to uncertainty about who is in or outside it and is likely to result in a TMD failing to meet the appropriateness requirements. For example, an issuer that is unlikely to have any funds to pay distributions in the short term should not have consumers seeking income as 'potentially' in the target market.

The design and distribution obligations require the issuer to clearly define the class of consumers that falls within the target market in order to meet the statutory test in s994B(8)(b). Issuers should ensure there is sufficient granularity to clearly delineate consumers in their target market and avoid using imprecise terms, such as a 'potential' rating.

Characteristics of consumers in the target market: Risk profile

Most issuers of investment products that we reviewed described the risk profile of consumers in their target markets. From our review of these issuers, we found that:

- issuers generally used a range of risk profiles (from 'low' to 'very high'), which were generally defined based on the Standard Risk Measure (SRM) and the consumers' risk profile
- issuers tended to designate a risk profile for consumers in the target market that appropriately reflected the risk level of the investment asset class (i.e. a 'low' risk profile for a product primarily invested in cash and money market instruments, 'high' to 'very high' risk for a product primarily invested in equities), and
- the risk tolerance of consumers in the target market tended to correlate with the observed level of returns volatility of the product (i.e. the assessed risk tolerances of consumers in a target market tend to be higher for investment products with higher volatility).

Generally, issuers assessed the risks of a scheme on a consistent basis and in line with the overall risk attributes of the product. However, through our stop order work we identified various issues with the use of risk profiles as highlighted under 'Areas for improvement'.

Areas for improvement

Inappropriate risk profiles were a factor in 21 of the 26 stop order actions taken against issuers of investment products to date. Specifically, we took action due to one or more of the following concerns:

- **Reliance on the SRM alone may be inadequate** – Reliance on the SRM as the only measure of risk was a factor in 10 of the 26 stop orders. Risk is multi-faceted, and the use of a single measure may be problematic. Issuers should consider all important indicators of risks that affect their product, including the drawdown (the quantum of negative returns when they are observed), returns volatility, and the risk that returns may be positive but not meet a consumer's objectives, financial situation and needs: see Case study 1.
- **Some issuers understated a product's risk level** – In doing so, they included consumers in the target market who had a risk tolerance that was misaligned with the actual risks of the product: see Case study 1. We also found that some issuers of very high-risk products understated the risk level of a product, by placing undue emphasis on a product's returns and not sufficiently considering the potential loss from investing in the product.
- **Some issuers took a narrow view of performance** – Issuers should not assume that past performance is always an indicator of future performance. To appropriately assess the risk level of a product, issuers should consider how a product is likely to perform both under conditions of market stress and average market conditions.

Case study 1: Inappropriate risk tolerance for target market

One TMD we reviewed used the SRM to assess the risks of a managed investment scheme that was invested in various asset classes with elevated risks. These asset classes included:

- direct individual loans and other debt instruments, which had small gains (through interest repayments) in years of positive performance but the risk of significant loss in the event of default
- property development projects, which carry the risk of total or significant capital loss if a project fails
- strategies involving short selling, leverage and derivatives, which can carry the risk of amplified capital loss, and
- private businesses, which come with valuation risks, given limited price discovery and market depth.

The issuer failed to sufficiently consider these risks when defining the target market for the scheme. After ASIC intervention, the issuer revised the risk tolerance that was set out in the TMD to address the specific risks across the scheme's investments, including the overall risk of significant or total capital loss, and only include in the target market consumers who have a 'very high' risk and return profile.

This stop order was lifted after the issuer satisfactorily addressed concerns with the TMD.

Characteristics of consumers in the target market: Portfolio allocation

Most issuers of investment products we reviewed identified in their target market specified percentages of a consumer's portfolio that should be allocated to their product. Levels of portfolio allocation are generally broken down into categories. For example, the FSC template for investment products uses the labels 'satellite', 'core' and 'solution'. These categories reflect different ranges of portfolio allocation using definitions to determine a product's level of diversification.

Areas for improvement

Including inappropriate levels of portfolio allocation in a target market was a factor in 10 of the 26 stop order actions we have taken against issuers of investment products to date. Specifically, we took action due to one or more of the following concerns:

- **Overstating levels of diversification** – Most issuers of investment products we reviewed used a product's level of diversification to determine levels of portfolio allocation for the target market. However, some issuers did not assess diversification properly to justify higher levels of portfolio allocation for a consumer: see Case study 2. We generally consider that an issuer should only treat an investment product as highly diversified where it is invested across multiple asset classes (excluding cash). Issuers should carefully assess the diversification of their product on this basis when defining their target market.
- **Broad ranges of portfolio allocation** – Some issuers of investment products we reviewed used broad ranges of portfolio allocation in a target market (e.g. 25–75%), which we found can capture unsuitable consumers in the target market. Issuers should describe levels of intended portfolio allocation with sufficient granularity in a TMD.
- **Assuming a diversified portfolio** – Many issuers of investment products we reviewed assumed a target market can be defined on the basis that consumers would hold the investment product as part of a well-diversified portfolio. Issuers should not make this assumption when assessing the appropriateness of a target market for the product. A product should be assessed as if the product could be held on a stand-alone basis: see RG 274.129.

Case study 2: Portfolio allocation levels for a managed investment scheme with low diversification

We reviewed the TMD for a managed investment scheme that was invested predominantly in Australian micro-capitalised companies (companies with a very small market capitalisation). The TMD described a target market that included consumers seeking to allocate up to 75% of their portfolio into the scheme. The scheme provided very limited diversification, through concentrated investments in this asset sub-class.

After ASIC intervention, the issuer amended its TMD to recognise that the level of portfolio diversification in the scheme was low and narrowed the target market to only include consumers who seek to allocate up to 10% of their portfolio into the scheme.

This stop order was lifted after the issuer satisfactorily addressed concerns with the TMD.

Characteristics of consumers in the target market: Intended investment timeframe and withdrawal needs

Many TMDs we reviewed addressed the intended investment timeframe and withdrawal needs of a consumer in the target market (i.e. how frequently the consumer needs to withdraw from a product).

We expect issuers of investment products to define a consumer's intended investment timeframe based on:

- the exact investment term of an investment product, where the product is close-ended, and
- the risks of an investment strategy, where a riskier strategy typically requires a longer time horizon for an investment.

We also expect that consideration of a consumer's withdrawal needs for an investment product would be based on:

- the liquidity features of an investment product, including any limitations on the ability of a consumer to redeem their product, and
- the usual timeframe for the issuer to process and meet a withdrawal request.

Based on our review of TMDs for investment products, issuers generally identified intended investment timeframes and withdrawal needs of consumers in the target market for their schemes that were appropriate.

In particular, we observed that:

- issuers tended to include consumers with a longer intended investment timeframe within the target markets for riskier schemes (i.e. schemes which have had volatile returns and historical price declines)
- schemes invested in riskier asset classes (e.g. equities) tended to include consumers who had longer intended investment timeframes in their target market (i.e. longer than consumers of products that are invested in lower risk asset classes, like government bonds)
- issuers tended to match consumers who had a high or very high-risk profile with a longer intended investment timeframe, and
- issuers tended to describe the withdrawal needs of consumers in the target market based on the usual timeframe for processing withdrawal requests from consumers.

Areas for improvement

Identifying an inappropriate intended investment timeframe and/or withdrawal needs in the target market was a factor in 18 of the 26 stop order actions that we have taken against issuers of investment products to date, due to one or more of the following issues:

- **High risk, but short investment timeframe** – A few issuers of very high-risk products indicated that consumers with a short investment timeframe were in the target market. We consider this is not consistent with the general view that typically, an investor should hold an investment in a higher risk product for a longer period of time to allow time for recouping losses.
- **Link between liquidity and withdrawal rights** – The ability to trade on a secondary market does not equate to withdrawal rights. If a consumer does not have a right to redeem their investment, the TMD should not indicate the product is suitable for investors who need withdrawal rights: see Case study 3.
- **Limitations on redemptions** – Where there are limitations on the redemptions for an investment product, these should be clearly reflected in the target market for the product. For example, an issuer should not include in the target market investors who have a need to withdraw money from a product every three months, when the issuer only offers redemptions to investors twice a year. Similarly, if meeting redemptions is at the issuer's discretion, the TMD should not indicate that the product is suitable for investors who need unconditional withdrawal rights.

Case study 3: Templates and withdrawal rights

One TMD we reviewed indicated that consumers requiring 'annual or longer' withdrawal rights were in the target market despite the product having only very limited and conditional withdrawal rights. The issuer explained this was because the product would be listed on ASX in the future. However, potentially being able to sell a product on market is not the same as having withdrawal rights. The issuer should have changed the template to refer to potential liquidity (instead of withdrawal rights) or kept the criterion but indicated that consumers who required withdrawal rights were not in the target market.

After ASIC intervention, the TMD was amended to a customised form of the FSC template to clarify that the product was not appropriate for consumers who needed the right to withdraw money before the end of the fixed term of the product. It was noted that consumers may be able to sell off-market but that a low level of liquidity may mean the exit price would be lower than the net tangible asset value.

This stop order was lifted after the issuer satisfactorily addressed concerns with the TMD.

Distribution conditions

Issuers must specify distribution conditions in their TMDs. These conditions are effectively limitations or restrictions on the distribution of a product (e.g. limiting distribution of a product to certain distribution channels).

Distribution conditions are one component of the controls that an issuer needs to implement to comply with the reasonable steps obligation: see Key observations: Distribution and oversight arrangements. These conditions should be specified in the TMD with tangible parameters, so that these conditions are objectively clear: see RG 274.97–RG 274.99.

We observed the following distribution conditions among issuers of investment products:

- requiring that consumers complete a questionnaire during the application process
- restricting a product's distribution to personal advice and/or platforms, and
- restricting a product's distribution to certain distributors that have been subject to due diligence by the issuer.

For example, prudentially regulated entities offering Additional Tier 1 securities (also known as hybrids) have chosen to restrict distribution of the product to retail investors who have received personal advice or wholesale investors.

These entities have also restricted distribution to specific channels, including where checks have been conducted on the relevant broker's credentials and experience with these complex securities.

Areas for improvement

- **Many issuers of investment products did not include any distribution conditions in their TMDs** – The absence of any distribution conditions was a factor in eight of the 26 stop order actions taken against issuers of investment products to date: see Case study 4. A TMD must have distribution conditions, given the requirements in s994B(8)(a). In other cases, the distribution conditions were inappropriate.
- **Consumer self-certification is not sufficient as a distribution condition** – Some issuers included a distribution condition requiring consumers to self-certify that they are in the target market for a product. This places the burden on the consumer to determine whether they are in the target market, based on their reading of the TMD. A distribution condition requiring self-certification was a factor in five of the 26 stop order actions that have been taken against issuers of investment products to date. Relying on a consumer to certify that they are in the target market is inconsistent with the objectives of the design and distribution obligations. The TMD is not a consumer-facing document, and the obligations place the responsibility on the distributor and issuer to understand their target market and direct distribution of a product to that target market: see RG 274.178.
- **Distribution conditions should be tailored for each product** – We observed that issuers typically choose from a prescribed list of distribution conditions set out in TMD templates. While templates may provide guidance around these items, issuers should always assess their own product and distribution arrangements to determine what conditions would be most appropriate for their target market.

Case study 4: TMD with no distribution conditions

A managed investment scheme had a relatively narrow target market, given the scheme's concentrated investments in residential property. The scheme's TMD had no distribution conditions, which is a breach of s994B(8)(a). We considered that this allowed the scheme to be distributed without restriction and reach a broad range of consumers, including those outside the target market.

After ASIC intervention, the issuer introduced 'knockout' questions to determine if a consumer is unlikely to be within the target market. The questions were designed around the target market and prioritised based on the issuer's assessment of the potential harm that might arise if a consumer were to proceed with the investment despite falling outside the relevant parameters of the target market.

This stop order was lifted after the issuer satisfactorily addressed concerns with the TMD.

Use of templates to prepare TMDs

TMD templates are frequently used by issuers of investment products. Generally, templates designed specifically for investment products have assisted issuers with preparing an appropriate TMD. However, we have seen issuers use templates inappropriately as noted in 'Areas for improvement'.

We found that the FSC template is the most commonly used template for investment products. The FSC template uses a set of indicators for identifying suitable consumers in a target market, including their risk tolerance, intended allocation of the product to their portfolio, their withdrawal needs, investment timeframe and investment objectives.

Well-designed templates may be a useful starting point for issuers. This is especially the case where the template is clear, standardised, contains a complete set of relevant parameters and can be easily customised, where required.

Areas for improvement

ASIC continues to caution industry not to use TMD templates in a 'tick-a-box' way. In all cases, issuers must critically assess and carefully consider the specific risks and features of their product to develop an appropriate target market: see RG 274.87–RG 274.88.

The responsibility lies with the issuer to properly understand the class of consumers whose likely objectives, financial situation and needs are met by their product. The issuer must ensure that the target market reflects this group of suitable consumers.

Inappropriate use of a template was a factor in 13 stop orders placed on investment products to date. Specifically, we took stop order action against these issuers due to one or more of the following concerns:

› **Use of templates without customisation** – We observed the inappropriate use of investment product templates where there is no customisation for the specific product: see Case study 5. A lack of customisation is especially problematic for products with unique features and/or elevated risks.

› **Use of inappropriate templates** – We observed some issuers of investment products using templates that are not tailored for investment products, in that they are designed to be used for a broad range of types of products (e.g. banking products). Issuers should ensure that if a template is used, it is fit-for-purpose.

Issuers that use templates should consider if they need additional information to properly assess a product's suitability for a consumer or if they should adjust pre-set categories in the template (e.g. around risk or levels of portfolio allocation) to capture a more appropriate range of consumers, as applicable to the product (e.g. an issuer may need to narrow or further detail pre-set risk profiles in a TMD template for higher risk investment products): see Case study 5.

Case study 5: Inappropriate use of template

An issuer used a template to set the target market of a managed investment scheme solely invested in a single asset that carried very high risks, due to its extreme price volatility. The issuer used pre-set categories within the template to set an inappropriately broad target market. The template, without customisation, was plainly unsuitable, given the scheme's investment strategy.

For example, the target market defined the risk tolerance of consumers based on the template's pre-set risk profiles, without addressing the unique and extreme risks of the scheme's strategy.

After ASIC intervention, the issuer customised the template to appropriately define the target market by including additional information to narrow the risk tolerance of consumers. The issuer also added more detail to other broad categories of consumer characteristics to reflect an appropriately narrow target market for the scheme.

This stop order was lifted after the issuer withdrew the product.

Key observations: Distribution and oversight arrangements

Issuers and distributors must take reasonable steps that will, or are reasonably likely to, result in distribution of a product being consistent with the product's TMD (reasonable steps obligation): see s994E. To meet this obligation, issuers and distributors must implement effective arrangements that are likely to direct distribution of the product to the target market: see RG 274.139.

To meet the reasonable steps obligation, an issuer must consider all aspects of a product's distribution, including the distributors, methods, marketing, controls and supervision: see RG 274.144.

In our initial review on issuers of investment products, we predominantly focused our regulatory action on non-compliance with the TMD requirements. In future, we plan to carry out surveillance work that focuses on compliance with the reasonable steps obligation and we will consider regulatory action where necessary.

The following observations on issuers' practices in complying with the reasonable steps obligation are based on our review of 12 issuers of managed investment schemes.

Note: See Appendix 2 for the methodology of our review.

Distribution strategy and sales process

When developing and implementing a distribution strategy or sales process, issuers should consider the context of a product's distribution (e.g. the website for the product, face-to-face sales design and marketing), alongside how the product structure is presented (e.g. product choices or features and how the price of a product is framed). All of these factors (i.e. the 'choice architecture') can affect the likelihood of a product's distribution being in line with the target market: see RG 274.145.

We observed the following good practices in the distribution strategy and sales process of the 12 issuers of managed investment schemes we reviewed:

- **Online marketing** – We observed one issuer using key words that are aligned with the target market to drive search engine optimisation and online marketing activity, and ultimately better direct a scheme's distribution to consumers in the target market. While this can be a good practice, issuers should always take care to ensure that any marketing does not contain false or misleading representations: see Regulatory Guide 234 *Advertising financial products and services (including credit): Good practice guidance* (RG 234).
- **Marketing and promotional checks** – Some issuers require that all marketing and promotional material undergoes a compliance check to ensure the material aligns with their TMDs and would not make it likely for consumers outside a target market to invest in a scheme. Checks involved looking at whether certain key terms or messages in material could induce consumers outside the target market to acquire interests in the scheme.
- **Distributor staff training** – Some issuers delivered regular training to distributor staff on the design and distribution obligations. The training would generally focus on building distributor understanding of a TMD and, more generally, obligations to ensure that staff can apply this knowledge when engaging with consumers or when responding to questions about a scheme.

- **Screening and information collection processes for prospective consumers** – Many issuers use various methods to collect information about prospective consumers of a scheme. These include the use of questionnaires to draw out the objectives, financial situation and needs of consumers or the use of existing information about the consumer that has been gathered through past distributions of other products by the issuer. Information collection tools of this kind may be useful as one part of an overall distribution strategy to meet the reasonable steps obligation, although we have had concerns about the use of questionnaires in some instances as noted below.

Areas for improvement

We have identified several areas for improvement in relation to the distribution strategy and sales process of the 12 issuers of managed investment schemes we reviewed:

- **Inappropriately shifting onus onto the consumer** – Some issuers asked consumers to simply acknowledge that they had read the TMD and Product Disclosure Statement (PDS), without taking any further steps to check if the consumer was in the target market. This is inappropriate.
- **Over-reliance on questionnaires** – Some issuers relied solely on questionnaires to try and direct distribution of a scheme to consumers in the target market. While questionnaires may be helpful to understand new customers, they are only one component of an issuer's distribution strategy and are unlikely to be adequate on their own for the purposes of meeting the reasonable steps obligation. For example, issuers should consider the effectiveness of their assessment process behind questionnaire responses to determine if a product is distributed to an applicant. Issuers should consider their distribution strategy and sales process in their entirety to determine if they meet the reasonable steps obligation, including the choice architecture they employ.
- **Inappropriate questionnaires** – We saw questionnaires that are inappropriate due to several issues. In particular, we were concerned about questionnaires that simply asked whether the consumer had each of the consumer characteristics in the target market based on their reading of the TMD and disclosure documents. Such questionnaires require investors to self-certify that they are in the target market, which is inconsistent with the purpose of the design and distribution obligations (i.e. to address over-reliance on disclosures). We were also concerned about questionnaires that address only part of a target market or confuse consumers into guessing answers, making errors or falsely representing their preferences. These are deficient.
- **Sales processes that are not audited or tested** – Most issuers did not test or audit their sales processes, either before or after a process was put in place. For example, issuers that used a questionnaire did not periodically audit questionnaire responses to test if a consumer had accurately completed the questionnaire or determine if the questionnaire was working as intended. As part of a broader set of monitoring practices, it is potentially a useful practice for issuers, particularly when using external distributors, to audit consumer questionnaire responses and test if the questionnaire is working as intended or needs improvement. Issuers should also consider if other information collection tools should be used to support an overall distribution strategy or sales process: see Key observations: Monitoring and review arrangements.

Third-party distributor arrangements

Most issuers of managed investment schemes we reviewed used third-party distributors. These include platform providers, sales staff or financial advisers who provide general advice.

To meet the reasonable steps obligation, issuers should assess the capacity of distributors to comply with distribution conditions and to meet the design and distribution obligations more broadly, including the likelihood of a distributor's conduct being inconsistent with the TMD: see Table 4 in RG 274.

We identified a number of good practices among the 12 issuers of managed investment schemes that we reviewed, including:

- implementing appropriate communication and oversight arrangements to monitor distributors
- assessing whether distributor staff are sufficiently trained on the design and distribution obligations and the TMD to appropriately sell the product
- reviewing the internal risk controls that are being used by the distributor
- reviewing the distributor's past conduct and history, including complaints history and any disciplinary action, and
- requiring distributors to provide evidence to substantiate that they meet the issuer's design and distribution processes and their obligations under the regime.

Areas for improvement

The issuers we reviewed can make the following improvements in relation to their third-party distributor arrangements:

- **Gather evidence that distributors are meeting the obligations** – Some issuers required distributors to simply self-certify that they are meeting the obligations, without requiring evidence or substantiation.
- **Require more detail from distributors** – Distributors typically provide very high-level information about their compliance practices. Greater detail can provide the issuer with more assurance.
- **Audit distributors' practices** – Issuers typically did not audit or verify whether a distributor's statements about their compliance practices were followed in practice.

Monitoring and supervisory arrangements

We generally consider the adequacy of an issuer's monitoring and supervisory arrangements in relation to the distribution of a product as part of our review of compliance with the reasonable steps obligation: see Table 4 in RG 274.

Effective monitoring and supervisory arrangements give the issuer proper oversight of the product's distribution and performance, including reviewing how over time, distribution activity continues to remain consistent with the original distribution strategy for a product.

Most issuers of managed investment schemes we reviewed had documented design and distribution policies. Issuers also established specialised committees on design and distribution compliance.

These committees included key personnel across the business (i.e. distribution, product, executive and compliance personnel) and generally provided the issuer with oversight of design and distribution related matters.

Areas for improvement

We noted the following areas for improvement among the 12 issuers of managed investment schemes that we reviewed:

- **Policies** – Some issuers merely restated their obligations under the regime in their policies and used the TMD as the only substantive and documented form of design and distribution obligation governance. We expect issuers to consider whether other documented processes, controls and systems are needed to ensure compliance with the TMD and obligations.
- **Ongoing monitoring** – Committees for overseeing compliance with the design and distribution obligations were typically proactive only during the development of a TMD and were generally inactive after product launch. We expect issuers to continuously monitor and respond to ongoing design and distribution issues across an issuer's business, whether through centralised working committees or another similar facility for oversight.
- **Ongoing board involvement** – For some issuers, ongoing board involvement with the design and distribution obligations tended to be perfunctory and limited to approval of the TMD when a scheme was launched. The obligations encompass all aspects of a product's life cycle, from its initial design, through to its distribution, monitoring and review. The board should be across compliance with the obligations across these stages and ensure it has ongoing and adequate oversight of the business's product governance, distribution and review arrangements.

Key observations: Monitoring and review arrangements

Issuers must review a TMD:

- at the end of the review periods that are specified in the TMD
- in response to review triggers (i.e. events or circumstances that would reasonably suggest the TMD is no longer appropriate)
- when other events or circumstances occur which reasonably suggest that the TMD is no longer appropriate (see s994C).

The issuer must remove the product from the market and direct distributors to stop distributing the product as soon as practicable, but in any event within 10 business days of a review trigger or when another event or circumstance occurs which reasonably suggests the TMD is no longer appropriate, unless the TMD has been reviewed, and if necessary, a new TMD made: see s994C(3)–(6).

If a review finds that the product is not operating as intended or presents significant consumer harms, the issuer must take action. An issuer may need to change a product's design, target market or distribution arrangements, or cease offering the product altogether.

Issuers must have in place arrangements to identify areas of likely consumer harm and other factors that may indicate a TMD review is required: see RG 274.152.

All 12 issuers of managed investment schemes we reviewed had arrangements in place for collecting information and reviewing their TMDs. While we observed potentially useful practices, there were also areas for improvement in relation to monitoring and review arrangements among these issuers.

Review triggers

Most issuers of managed investment schemes we reviewed had arrangements in place to identify when a review trigger or other event or circumstance suggesting a TMD was no longer appropriate had occurred. Issuers considered several factors, including:

- the number of complaints received directly from consumers and from distributors
- distributions outside the target market
- significant changes in product performance, such as deviations from an investment benchmark and changes in investment strategy
- changes in the number of withdrawal requests, and
- economic or market conditions that affect investments in a scheme.

We found that issuers generally had a framework in place to monitor review triggers or other events or circumstances that would prompt the issuer to conduct a review.

Areas for improvement

Some issuers of managed investment schemes we reviewed used review triggers that lacked specificity and required more detail. Issuers should consider a fuller range of factors that can help them identify if a TMD is no longer appropriate: see RG 274.107 and Example 7 in RG 274 for specific factors that issuers of managed investment schemes can consider.

Conducting a review

Both periodic reviews and reviews in response to review triggers or other events or circumstances that would indicate a TMD is no longer appropriate (i.e. reactive review) should take into account all available information about a product. This should include multiple data sources relating to the issuer's distribution activities and consumer outcomes: see RG 274.154–RG 274.155.

When reviewing a TMD, issuers should aim to minimise the risk of a product being sold to unsuitable consumers by considering, for example, whether:

› the product continues to meet the likely objectives, financial situation and needs of the target market it was designed for, or

› the product's performance is materially different from what the issuer originally expected and communicated to the distributor or consumer at the time of sale: see RG 274.156.

Most issuers we reviewed documented a checklist or process for both periodic and reactive reviews. Some issuers reviewed and confirmed analyses conducted on a scheme to determine if the performance and risk metrics (e.g. returns and volatility data) still supported the target market.

All issuers anticipated the need to revise a scheme's design, TMD or distribution practices as a result of either a periodic or reactive review.

Areas for improvement

Within the review framework, issuers of managed investment schemes should consider the following:

› **Reactive reviews** – Checks should be targeted and address the issues with the TMD or scheme raised by the relevant review trigger, event or circumstance. For example, if a review trigger occurs due to the nature and volume of complaints about a scheme, the review should focus on the issues that are raised in the complaints.

› **Periodic reviews** – Checks should be comprehensive and cover all aspects of a TMD and scheme to ensure they are working as intended.

Many issuers set out general checks in their review frameworks, rather than specify different checks that are relevant to their varying review triggers. Issuers should consider tailoring their review framework to best ensure they can identify areas of likely consumer harm and any changes required by the scheme or TMD.

Many issuers we reviewed did not have documented procedures for assessing the adequacy of their distribution arrangements and conditions. We expect issuers to test whether distribution arrangements and conditions remain adequate and appropriate, including assessing distribution channels and analysing distribution outcomes.

Specifically, issuers should test whether:

› distribution conditions are working as intended (e.g. where a distribution condition outlines the use of a questionnaire, whether the questionnaire elicits the right information for an issuer to properly assess whether consumers are in the target market), and

› third-party distributors remain competent and suited to distribute a scheme (e.g. by auditing sales practices or distributor training on the design and distribution obligations, or looking at distribution outcomes, such as the number of consumers who are outside the target market and invest in the product via the distributor).

None of the issuers we reviewed had contingencies for discontinuing a scheme because of a review. Issuers should consider whether a scheme may need to be removed from the market altogether due to significant consumer harms (e.g. significant losses or where a scheme's investment strategy becomes unviable).

Appendix 1: The design and distribution obligations

Purpose of the design and distribution obligations

The design and distribution obligations assist consumers to obtain appropriate products and require issuers to distribute those products in a targeted manner.

The obligations address the shortcomings of disclosure and are ultimately intended to reduce the risk of harm caused by poor product design and distribution.

What issuers must do to comply

Issuers of financial products must comply with the design and distribution obligations if they are required to prepare a PDS or a prospectus.

To comply with the obligations, issuers must:

› prepare a TMD which must describe an appropriate target market, specify appropriate distribution conditions and meet a number of content requirements, including information relating to the review and monitoring of the financial product, and

› take reasonable steps to make it likely for the financial product to reach consumers in the target.

Issuers must also:

› monitor and review outcomes for consumers who have obtained the financial product, and

› consider whether changes to the financial product, the way it is distributed or to whom it is being provided (based on how the financial product performed for specific consumers and whether it resulted in poor outcomes for those consumers) are required.

We may take action where there are breaches of the design and distribution obligations by using our stop order powers and/or pursuing civil or criminal penalties (up to 2.5 million penalty units).

Appendix 2: Methodology of our review

Managed investment schemes

We undertook a broad review of the TMDs for approximately 3,650 registered managed investment schemes (as at June 2022). These schemes were identified through the following filtering exercise:

- We created a data set of information about the schemes' TMDs, and key risk and performance metrics such as historical returns, volatility of those returns, and the schemes' asset allocations. This included information for approximately 1,800 products (which includes separate unit classes of registered schemes).
- We analysed this data set to determine if there were potential concerns with a TMD based on a possible mismatch between a scheme's features and the TMD.

A subset of around 75 schemes identified from this exercise were further assessed. This involved reviewing their TMDs, disclosure documents and other publicly available materials. We also reviewed other TMDs in response to reports of misconduct after a risk assessment of schemes in the market.

Separately, 12 issuers of managed investment schemes were selected for a review of their product oversight, distribution and review arrangements. This review covered issuers varying in size (by funds under management) and products of various investment strategies (e.g. equities, fixed income, property).

This review was undertaken to check the extent of compliance with the reasonable steps and review obligations across different sectors of the funds management industry.

Other investment products

We also reviewed the appropriateness of TMDs for other investment products offered under Ch 6D of the Corporations Act, including shares issued by investment companies, preference shares, Additional Tier 1 securities issued by prudentially regulated entities and debentures.

We selected the TMDs for review by assessing all retail offers of these Ch 6D products since 1 March 2022 using risk-based criteria relating to the terms of the product, the underlying business model or asset allocation (as relevant), past performance, the size of the offer, and the nature of the offer (e.g. if the offer was only open to persons associated with the company).

Over the review period, we identified 119 offers under Ch 6D that were subject to the design and distribution obligations and took the following action:

- TMDs were reviewed for 35 offers after risk assessment.
- ASIC action was taken on 14 of the 35 offers, involving seven stop orders and seven negotiated outcomes.

Note: In circumstances where there is no immediate harm to investors because the product cannot be issued to investors, it may be appropriate for ASIC to accept a negotiated outcome of either the withdrawal of the offer or revisions to the TMD.

Key terms and related information

Key terms

Corporations Act	*Corporations Act 2001*, including regulations made for the purposes of that Act
design and distribution obligations	The obligations contained in Pt 7.8A of the Corporations Act
distributor	Means a regulated person as defined in s994A(1) of the Corporations Act
FSC	Financial Services Council
investment products	Managed investment schemes and other investment products, including shares issued by an investment company, preference shares and debentures
issuer	A person who is subject to the TMD requirements in s994B (including sellers in a regulated sale situation), unless indicated otherwise
managed investment scheme	Has the meaning in s9 of the Corporations Act
PDS	A Product Disclosure Statement – a document that must be given to a retail client for the offer or issue of a financial product in accordance with Div 2 of Pt 7.9 of the Corporations Act **Note:** See s761A for the exact definition.
responsible entity	A responsible entity of a registered scheme as defined in s9 of the Corporations Act
RG 274 (for example)	An ASIC regulatory guide (in this example, numbered 274)
s994E (for example)	A section of the Corporations Act (in this example numbered 994E), unless otherwise specified
Standard Risk Measure (SRM)	The SRM is based on industry guidance to allow members to compare investment options that are expected to deliver a similar number of negative annual returns over any 20-year period: see Standard Risk Measure Guidance Paper for Trustees, FSC and ASFA (PDF, 346 KB)
target market	The class of consumers described in the TMD for the product under s994B(5)(b) of the Corporations Act
target market determination	Has the meaning given in s994B of the Corporations Act
TMD	A target market determination document

Related information

Headnotes

Design and distribution obligations, issuers, managed funds, product design, reasonable steps obligation, responsible entities, target market determination, TMD

Legislation

Corporations Act 2001, s994A(1), 994B, 994C, and 994E

Treasury Laws Amendment (Design and distribution obligations and Product Intervention Powers) Act 2019

ASIC documents

REP 754 *Target market determinations for small amount credit contracts*

RG 234 *Advertising financial products and services (including credit): Good practice guidance*

RG 274 *Product design and distribution obligations*

22-194MR *ASIC's first DDO stop orders to prevent offer of financial products to consumers*

22-236MR *Super trustees urged to improve effectiveness of target market determinations*

22-252MR *ASIC places interim stop orders on Australian Residential Property Fund and Private Property Trust No. 20*

22-266MR *ASIC places interim stop order on APIL Essential Retail Income Fund*

22-278MR *ASIC places interim stop orders on Holon crypto funds*

22-284MR *ASIC places interim stop order on Westlawn Income Fund*

22-308MR *Interim stop order on offers from Neldner Road Vintners Limited*

22-309MR *ASIC places interim stop order on offers from Finnia Income Limited*

22-323MR *Interim stop orders placed on MPG Funds Management Limited's property trusts*

22-326MR *ASIC places interim stop orders on two Perpetual funds*

22-334MR *Interim stop order placed on offers from APS Savings Limited*

22-335MR *Interim stop orders placed on three funds from Australian Fiduciaries Limited*

22-338MR *ASIC takes civil penalty action against American Express Australia in first court case alleging breaches of design and distribution obligations*

22-361MR *ASIC takes further civil penalty action for breaches of design and distribution obligations*

23-002MR *Interim stop order placed on the Pivotal Diversified Fund*

23-068MR *ASIC issues interim stop orders on three BT Advance Asset Management funds*

23-092MR *CVC Limited makes changes to TMD following ASIC stop order*