

Finance, Competitiveness & Innovation Global Practice

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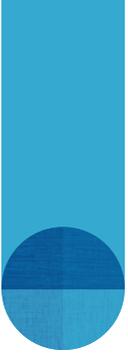
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ACRONYMS AND ABBREVIATIONS

ASIC	Australian Securities and Investments Commission
COFI Bill	Conduct of Financial Institutions Bill – consultation draft, 2018 (South Africa)
Corporations Act	Corporations Act, 2001 (Cth)
Cth	Commonwealth of Australia
DDO Act	Treasury Laws Amendment (Design and Distribution Obligations and Product Intervention Power) Act, 2019 (Cth)
DDO Bill Explanatory Memorandum	Treasury Laws Amendment (Design and Distribution Obligations and Product Intervention Power) Bill, 2018 (Cth) Revised Explanatory Memorandum
DDO Proposals Paper	Australian Government Design and Distribution Obligations and Product Intervention Power – Proposals Paper, 2016
Draft DDO Regulations	Draft Corporations Amendment (Design and Distribution Obligations and Product Intervention Powers) Regulations, 2018 (Cth)
EBA	European Banking Authority
EBA Guidelines	European Banking Authority Guidelines on Product Oversight and Governance for Retail Banking Products, 2015
EBA Final Report	EBA Guidelines: Final Report, 2015
EU	European Union
FCA	Financial Conduct Authority (UK)
FCA Glossary	FCA Handbook of Rules and Guidance – Glossary
FCA TCF Outcomes Guidance	FCA Guidance on Fair Treatment of Customers, 2015 (UK)
FCP	financial consumer protection
FSCA	Financial Sector Conduct Authority (South Africa)
FSI Final Report	Financial System Inquiry: Final Report, 2014 (Australia)
FSMA	Financial Services and Markets Act, 2000 (UK)
FSP	financial service provider
FSRA	Financial Sector Regulation Act, 2017 (South Africa)
HKMA	Hong Kong Monetary Authority
HKMA TCF Charter	HKMA Treat Customers Fairly Charter
HKMA TCF Examples	HKMA Examples of Measures to Implement Treat Customers Fairly Charter, 2014
MiFID II	Markets in Financial Instruments Directive 2014/65/EU

MiFIR	Regulation (EU) No 600/2014
National Credit Act	National Consumer Credit Protection Act, 2009 (Cth)
PDD	product design and distribution
POG	product oversight and governance
Sourcebook	FCA Product Intervention and Product Governance Sourcebook (UK)
UK	United Kingdom



EXECUTIVE SUMMARY

Regulation of product design and distribution of financial products, including retail banking products, has been increasing. Policy makers are finding that financial consumer protection measures implemented to date, while still important, are insufficient to protect consumers against all key risks. Anticipating new or changing risks to consumers has become more difficult for regulators due to rapid financial sector innovation. Technological advancements are increasing the scale of potentially adverse consumer issues resulting from financial products or their distribution. These issues are especially acute in environments with low levels of financial inclusion, where consumers are likely to have limited financial capability.

The aim of regulating financial service providers' oversight and governance arrangements for product design and distribution is to ensure that financial products distributed in a market are designed to meet the needs of consumers in that market. As with other financial consumer protection measures, the long-term aim is to ensure fair treatment and encourage trust in the financial sector. In turn, increased trust can lead to higher levels of financial inclusion and resultant benefits for individual consumers as well as the broader economy.

This Discussion Note discusses emerging approaches for regulating oversight and governance arrangements for the design and distribution of common retail banking products (that is, deposit, credit, and payment products). These are usually the products first acquired by financial consumers, and significant developments in product design and distribution regulation have recently occurred with respect to such products. The emerging approaches identified in this Note are drawn from existing or proposed rules in a number of jurisdictions, including Australia, the European Union, Hong Kong, South Africa, and

the United Kingdom, as well as from international commentary on regulating product design and distribution regulation.

Typical elements of product design and distribution regulatory frameworks for retail banking products observed from the regimes considered in this Discussion Note include the following, in summary:

- **Policy aims:** The main focus is on requiring financial service providers to put in place product oversight and governance arrangements designed to ensure that financial products meet the needs of consumers in target markets or market segments. The long-term objective of such rules is to encourage fair treatment and trust in the financial system by reducing the number of consumers being sold products that do not match their needs and consequent consumer detriment.
- **Coverage:** Product design and distribution rules tend to apply to both product issuers/manufacturers and distributors. However, there is significant variation in product coverage. Some regimes apply to all or most retail banking products, while others apply only to limited types. Rules are generally confined to products offered to a consumer (typically individuals, sometimes also small businesses) or its equivalent concept in a jurisdiction.
- **Requirements for governance arrangements:** A core element of such frameworks are obligations to establish and implement clear, documented product oversight and governance arrangements. These should be supported by measures such as clearly articulated internal roles and responsibilities for product design and distribution and requirements for senior management and all relevant functional areas to be involved in the decision-making process.

- **Requirements for target market assessments:** A core element of product design and distribution regulation is the need for an assessment of the target market when a product is being developed. The target market is generally described as the group(s) of consumers for whom a particular product is intended by the issuer or manufacturer. Target market assessments are typically the responsibility of the product issuer/manufacturer, but distributors may also be required to undertake an assessment in connection with their distribution. Key requirements are to identify the target market and then to ensure that a product is designed so that it is suitable for that target market. These requirements can be supported by explicit obligations to undertake product testing.
- **Distribution requirements:** Distribution channels and distributors are required to be appropriate for consumers in the target market for a product. Issuers/manufacturers typically have a range of obligations to screen and monitor their distributors and exchange information with them, to ensure appropriate distribution of their products. Distributors also typically have several key obligations, including to distribute a product consistently with its target market assessment and instructions from its issuer/manufacturer.
- **Requirements for post-sale product reviews:** Following product launch, the issuer/manufacturer (in consultation with third-party distributors and other key stakeholders) may be required to review the product and related disclosure materials periodically. The aim would be to assess whether the product still meets the

needs of the target market and to identify possible follow-up actions.

- **Proportionality:** While rules on product design and distribution can be applied to all retail banking products (no matter how simple or complex), their application should follow a proportionate, scalable approach. They should be flexible enough to take into account the nature, scale, and complexity of the business of the relevant institution as well as the complexity and risk of the product.

Some jurisdictions also provide complementary product intervention powers to regulators. Such powers can be used to impose restrictions on the marketing, distribution, or sale of specified products. These powers may be used where there is evidence that a financial product has resulted in, or will likely result in, significant detriment to retail clients that cannot be remedied in any other way.

This Note discusses such emerging approaches in more detail and is intended as the beginning of an ongoing discussion on trends and lessons in good practices for regulating product design and distribution of retail banking products. Many jurisdictions are still in the process of developing or implementing such rules. To date, such frameworks have tended to be implemented in developed countries, at times through complex and extensive regulation. Developing countries may need to consider implementing more streamlined requirements, at least initially. There is much scope for future research and analysis on these topics, including concerning supervisory experiences and challenges and impact assessments.



1. INTRODUCTION

Globally, there has been an increasing trend and interest in regulating product design and distribution (PDD) in the financial sector. Policy makers are recognizing that traditional financial consumer protection (FCP) approaches, while still important, are not sufficient to protect consumers fully. New or changing risks for consumers due to innovations in the financial sector have increased the challenges faced by regulators. These issues are heightened in environments with rapid technological developments and low levels of financial capability.

This Discussion Note highlights emerging approaches for regulating financial service providers' (FSPs) oversight and governance arrangements for the design and distribution of retail banking products. The emerging approaches discussed in this Note are drawn from existing or proposed laws or nonbinding guidance issued by regulators, referred to in the Note as PDD regulation, regulatory frameworks, or rules.

The focus of this Discussion Note is on common retail banking products (deposit, credit, and payment products), as these are usually the products first acquired by financial consumers and significant developments in PDD regulation have recently occurred with respect to such products. The focus is primarily on individuals who acquire such products for personal or business purposes, although they may also include micro or small businesses run by entities other than individuals.

This Discussion Note provides case studies of relevant PDD regulation in Australia, the European Union (EU), Hong Kong, South Africa, and the United Kingdom (UK)

and an overview of international commentary on PDD. The Note also takes into account lessons learned from product design requirements from other financial sectors beyond banking (for example, structured investment products and insurance).¹

The remainder of this Discussion Note is organized into the following sections and topics:

- Section 2: What PDD regulation is and how it relates to other types of product regulation
- Section 3: Factors driving the increasing focus on PDD regulation
- Section 4: A summary of the case studies considered for the purposes of the Note and an overview of various international commentary
- Section 5: Emerging approaches based on such case studies and international commentary
- Section 6: Product intervention powers for regulators
- Section 7: Suggestions for further areas of research
- Annex: Detailed case studies

2. WHAT IS PDD REGULATION AND HOW DOES IT RELATE TO OTHER FCP AREAS?

What is PDD Regulation

PDD regulation refers to regulation of FSPs' oversight and governance arrangements for the design and distribution of financial products—in this context, core banking prod-

1. See, for example, Securities and Futures Commission (Hong Kong) 2016, European Securities and Markets Authority 2014, International Organization of Securities Commissions 2013, European Supervisory Authorities 2013, Financial Services Authority 2012, and Australian Financial Markets Association 2012.

ucts aimed at the retail market. There is increasing recognition that PDD rules are needed for an effective FCP framework in relation to retail banking products. Such rules may also benefit industry through increasing customer focus and retention and strengthening internal risk management.

The main components of PDD regulation comprise obligations on FSPs to have internal product oversight and governance (POG) arrangements for designing products (and making product changes) that meet the needs of consumers in an intended target market and for ensuring that such products are then distributed consistently with the intended target market. These components are supported by a range of supporting elements, such as requirements governing how product issuers and distributors interact in connection with PDD.

The policy aim of PDD rules is for FSPs to offer and distribute to consumers more appropriately designed and targeted products. The focus is on reducing the risk that consumers are offered unsuitable, harmful products, encouraging FSPs to create fair value for consumers, and helping to create a more level playing field for competitors based on responsible practices with regard to product characteristics.

How PDD Regulation Differs from Product-Related Measures

PDD regulation can be distinguished from other types of FCP measures that relate to product regulation. This Discussion Note does not cover these other types of measures. However, it is important to note that they can serve purposes that complement PDD regulation as part of a comprehensive FCP framework.

Product suitability rules

Product suitability requirements focus on interactions with individual consumers. In broad terms, product suitability rules create an obligation for an FSP to assess whether a particular product meets the financial objectives, needs, and capability of an individual customer. For example, responsible lending rules are a type of product suitability requirement. Such rules typically apply at the product acquisition stage or when obtaining personal financial advice. Product suitability rules can serve complementary goals and be used in combination with PDD rules but

should not be considered a substitute for PDD rules. Unlike product suitability rules, PDD rules apply proactively and at a market-wide level, aiming to ensure in advance that products are not offered outside an appropriate target market.

Rules mandating provision of basic banking products

A number of jurisdictions have introduced regulatory or industry-mandated requirements for the provision of basic bank accounts designed in advance to meet the needs of low-income and unbanked consumers. For example, the EU, Canada, India, and Brazil have established such requirements.² This Discussion Note focuses on oversight and governance arrangements for the design and distribution of retail banking products, rather than specific requirements for mandated products.

“Privacy by Design” rules

As with PDD, this regulatory approach emphasizes the need for entities to be proactive in preventing harm to individuals, but in this case with respect to privacy. The focus of privacy-by-design rules is on incorporating privacy considerations into all stages of building the information systems, business processes, and networked architecture of an entity.³ Product development may constitute one element of this process, but it is not the main focus. The EU General Data Protection Regulation is a leading example of a regulatory approach requiring implementation of privacy-by-design principles.⁴ Under Article 25 (“Data protection by design and by default”), a data controller is obliged to implement appropriate technical and organizational measures both when determining the means by which it will process personal data and when actually processing it, to protect the rights of data subjects and minimize unnecessary collection or processing of such data.

Regulatory sandboxes and policy initiatives on innovation

Financial regulators are increasingly using a variety of means to assess and manage the benefits and risks of technological developments in financial markets. Relevant regulatory and policy initiatives include the use of regulatory sandboxes and innovation hubs and accelerators for both traditional providers and newer “FinTech” entities.⁵ Such initiatives may involve assessing products, distribution channels, providers, and business models as well as some elements of FCP. The objectives of such initiatives are generally to foster innovation while also managing relevant risks, including, but not limited to, consumer risks.

2. For an outline of these examples, see World Bank Group 2018, pages 28–31.

3. Cavoukian 2011.

4. Regulation (EU) 2016/679.

5. See Jenik and Lauer 2017 and Zetzsche et al. 2017.

Such initiatives are therefore outside the scope of this Discussion Note, although one of their objectives may be to facilitate the design of financial products and services to meet customer needs better.

Complementary Regulatory Powers on Product Intervention

Product intervention powers for regulators may be included with or alongside PDD rules. Relevant provisions may allow regulators to ban the sale of products (to all customers or to specific sets of customers), require the amendment or withdrawal of marketing materials, or require FSPs to make changes to products. This Discussion Note provides examples of such powers.

3. WHY IS THE FOCUS ON DESIGN AND DISTRIBUTION OF FINANCIAL PRODUCTS INCREASING?

Policy makers around the world are increasingly putting in place PDD rules for financial products due to a range of challenges they face, including the following:

- Disclosure of information to consumers has proven to be insufficient in fully addressing consumer risks. Consumer protection frameworks have traditionally relied heavily on requiring FSPs to follow good practices in terms of disclosing prices, terms and conditions, and appropriate advice to consumers.⁶ Disclosure requirements can help consumers make informed decisions regarding the products they select, increasing consumer welfare. However, it is increasingly recognized that disclosure is by no means a complete solution—for example: “disclosure can be ineffective for a number of reasons, including consumer disengagement, complexity of documents and products, behavioural biases, misaligned interests and low financial literacy.”⁷
- In the absence of regulation, industry participants’ POG arrangements are frequently inadequate. For example, when consulting on the then proposed PDD rules for the EU on retail banking products, the European Banking Authority (EBA) described a number of conduct issues identified by Member States, such as distribution of specific types of mortgages originally targeted at a niche group of borrowers but subse-

quently sold to consumers beyond that target market, many of whom could not afford them.⁸

- Rules on product and advice suitability are not designed to address whole-of-market design or distribution issues. As noted above, product suitability rules relate to the need for a provider to assess whether a product meets the financial objectives, needs, and capability of an individual customer, rather than focusing up front on the characteristics of the whole target market. This assessment is done after the product has already been designed and introduced into the market. Further, such rules typically apply only when a consumer is actively applying for a product or receiving specific advice. In addition, it may be impractical to require that such assessments be undertaken for every customer, especially in relation to digital financial services (such as simple payment products).
- Technological developments are expanding the range of potential risks posed to consumers by innovative financial products and distribution channels. For example, technological developments such as big data, machine learning, and artificial intelligence increase the market reach of FSPs and exponentially increase the speed with which FSPs can assess, offer, and sell products to consumers.⁹ As a result, many products can now be distributed to consumers via “push” marketing (that is, without the consumer requesting such products) and without consumers having the opportunity to obtain advice, ask questions, or take the time to consider the suitability of the product to their needs (for example, digital credit). Such risks cannot be fully addressed through disclosure or market-conduct regulation at the point-of-sale stage but may instead require the earlier-stage, more proactive intervention that PDD rules provide.
- The above issues are likely to be exacerbated in environments with low financial capability.

These challenges have led policy makers to focus on provider behavior before the point of sale in order to protect consumers more proactively and comprehensively. The focus becomes preventing consumers from being exposed to consumer risks, rather than arming consumers with information to avoid such risks. This change in focus shifts the responsibility from consumers being better informed to protect themselves; instead, PDD rules place a greater onus on providers.

6. See, for example, Organisation for Economic Co-operation and Development 2011, Principle 4, and World Bank Group 2017, Chapter 1, Section B, “Deposit and Credit Products and Services.”

7. See, for example, Australian Government the Treasury 2014, page 199.

8. EBA 2014, page 7.

9. For a discussion of consumer risks with these developments, see Grady, Montes, and Traversa 2018.

It is also in the interests of FSPs to have fair product design standards. Given that PDD rules should result in more appropriately designed and targeted products, FSPs that are focused on creating value for consumers will have an increased ability to attract new customers and retain and deepen existing customer relationships.¹⁰ The number of enquiries and complaints from consumers are likely to decrease. For example, if credit products are targeted to segments where there is a clear need and capacity, then the risk of over-indebtedness (and corresponding loss) should be reduced.

PDD rules can also assist regulatory efficiency, as well as effectiveness. For example, the report that led to the introduction of Australia's new PDD laws noted the following:

“This [product design regulation] option would deliver benefits to industry, including strengthening internal risk management for product design, which may mitigate future problems, as well as signaling a higher level of customer focus. This approach should also avoid new, more complex and interventionist regulation in the future, promoting efficiency in the financial system overall.”¹¹

4. INTERNATIONAL EXAMPLES

Country Case Studies

A range of jurisdictions have introduced or are introducing PDD regulatory frameworks that apply to some or all retail banking products. This Discussion Note examines the following five such jurisdictions from around the world (and the EU covers a number of countries):

- **Australia:** Australia recently passed legislation that imposes PDD rules in relation to most retail banking products, other than credit. It also gives the regulator, the Australian Securities and Investments Commission (ASIC), product intervention powers that would cover all such products, including credit. The new regime was introduced by the Treasury Laws Amendment (Design and Distribution Obligations and Product Intervention Power) Act (Cth) 2019 (DDO Act), amending the Corporations Act, 2001 (Cth) (Corporations Act) and the National Consumer Credit Protection Act 2009 (Cth) (National Credit Act). Supporting regula-

tions are proposed in the Draft Corporations Amendment (Design and Distribution Obligations and Product Intervention Powers) Regulations, 2018 (Draft DDO Regulations). The regime will come into effect in 2021.

- **EU:** The EBA recently introduced legally binding guidelines—EBA Guidelines on Product Oversight and Governance for Retail Banking Products, 2015 (EBA Guidelines)—imposing PDD rules in relation to all retail banking products that are expected to be implemented by individual Member States. In addition, Regulation (EU) No 600/2014 (MiFIR) gives product intervention powers for some products to both the EBA and regulators in individual Member States.
- **Hong Kong:** Several years ago, the Hong Kong Monetary Authority (HKMA) introduced a new Treat Customers Fairly (TCF) Charter containing principles that banks agreed to be bound by, including, among others, a high-level PDD obligation supported by some limited guidance from the HKMA.
- **South Africa:** South Africa is in the process of introducing a new FCP regulatory regime comprising, among other measures, PDD requirements applying to a range of products, including retail banking products. The regime is proposed in the Conduct of Financial Institutions Bill—consultation draft, 2018 (COFI Bill). The FCP regulator, the Financial Sector Conduct Authority (FSCA), will also be given new product intervention powers.
- **UK:** The Financial Conduct Authority (FCA) has included PDD rules and related guidance in its Handbook of Rules and Guidance for financial firms, in a chapter called “Product Intervention and Product Governance Sourcebook” (Sourcebook). Relevantly in this context, these rules apply to structured deposits,¹² but not to other retail banking products. The FCA has also been given powers in the Financial Services and Markets Act, 2000 (FSMA) to make temporary and permanent product interventions applicable to such deposits under a separate regime.

Table 1 below summarizes and compares at a high level each of these regimes as applicable to retail banking products. The case studies set out in the annex provide a more detailed summary of each regime.

10. See Consultative Group to Assist the Poor 2016, page 12.

11. Australian Government the Treasury 2014, page 203.

12. Being, in summary, a deposit in relation to which interest or a return is determined according to a formula that takes into account factors such as one or more indices, one or more financial instruments, one or more commodities or other assets, or one or more foreign exchange rates. See FCA Handbook of Rules and Guidance—Glossary.

TABLE 1: Country Case Studies: Summary of Key PDD Rules

KEY RULES	AUSTRALIA	EU	HONG KONG	SOUTH AFRICA	UK
Retail banking products covered	PDD rules generally apply to all financial products provided to retail clients (being individuals and small businesses), excluding consumer credit products. Product intervention powers generally apply to all retail banking products, including consumer credit products.	PDD rules apply to credit, deposit and payment products offered and sold to consumers (being individuals acquiring products for non-business/professional purposes). Relevant product intervention powers are more limited, applying to financial instruments (which include structured deposits).	PDD rules apply to banking products and services. No specific product intervention powers.	Full range of financial products, including retail banking products. More onerous PDD requirements apply in relation to retail financial customers.	PDD rules apply to structured deposits. Product intervention powers apply to regulated financial products more broadly.
Key obligations for product issuers/manufacturers	<ul style="list-style-type: none"> • Must determine the target market for any product they develop (target market determination). • Over time, must review a target market determination to ensure it remains appropriate. • Must take reasonable steps to ensure that a product's distribution will be consistent with the target market determination. • Must notify the regulator of any significant dealings in the product inconsistent with its target market determination. 	<ul style="list-style-type: none"> • Must establish, implement, and review effective POG arrangements. • Primary responsibility for identifying and specifying a product's target market, along with product testing obligations. • Should select distribution channels that are appropriate for the particular target market and take all reasonable steps to ensure that distributors comply with their product governance arrangements. • Should provide distributors with clear, up-to-date, and precise information about the product, enabling them to understand the product and properly place it in the market. • Responsible for product monitoring and should do so on an ongoing basis. If a problem is identified, should take necessary action to mitigate the situation and prevent further detriment. 	<p>Banks must comply with the principle that banking services and products should be designed to meet the needs of customers. The HKMA's guidance notes that this means banks should design services and products that meet the needs of their target customer segments.</p>	<ul style="list-style-type: none"> • Must establish and implement product oversight arrangements relating to the design of financial products. • Each new financial product must be signed off by the institution's governing body before it is marketed, and this sign-off must be accompanied by a confirmation that the product, its distribution methods, and its disclosure documents all meet the requirements for financial product oversight arrangements. • Must also undertake a thorough assessment of the target market when developing a new product and its distribution methods and disclosure documents. • Must give adequate information about the product to distributors. • Products must be subject to ongoing monitoring and periodic review of product performance. 	<ul style="list-style-type: none"> • Must identify the potential target market for each product. • Must have governance arrangements in place to ensure that products are designed having regard to the target market. • Must comply with product testing obligations, including undertaking a scenario analysis for their products. • Should share information with distributors to allow each other to meet their obligations. • Must regularly review their products and target market determinations.

TABLE 1, continued

KEY RULES	AUSTRALIA	EU	HONG KONG	SOUTH AFRICA	UK
Key obligations for product distributors (including issuers/manufacturers who self-distribute)	<ul style="list-style-type: none"> • Must not engage in retail product distribution conduct unless a target market determination is in place. • Must take reasonable steps to act consistently with the determination. • Must not distribute a product when its target market determination may not be appropriate. • Must collect and provide distribution information to product issuers. • Must notify the issuer of any significant dealings in a product inconsistent with its target market determination. 	<ul style="list-style-type: none"> • Must establish, implement, and review effective POG arrangements. • Distributors should use this information, along with their own knowledge, to determine whether a consumer belongs in the target market. • Distributors should collect relevant information in order to assist manufacturers with product monitoring. 		<ul style="list-style-type: none"> • Must take all reasonable steps to ensure that distribution or advice channels act in compliance with the objectives of their governance policy or distribution model. If distributors become aware of a problem, they must take remedial action. • Must regularly monitor whether products are being distributed to the target market. 	<ul style="list-style-type: none"> • Must identify the potential target market for each product they distribute and their distribution strategy. • Must have governance arrangements in place to ensure that products are distributed having regard to the target market. • Should share information about a product with its manufacturer to allow each other to meet their obligations. • Must regularly review their products and target market determinations.
Product intervention powers	ASIC may make a product intervention order if satisfied that a product has resulted, or will or is likely to result, in significant detriment to retail clients. Such an order can prohibit a person from engaging in specified conduct in relation to the specified class of products, either entirely or unless they meet specified conditions.	The EBA has powers to temporarily prohibit or restrict a type of financial activity or the marketing, distribution, or sale of particular structured deposits. (Regulators of Member States are also given powers to make similar orders, temporarily or permanently)	N/A	The FSCA may prescribe conduct standards, including those that prohibit or restrict the offer of products to certain types of customer or the offer of certain products.	The FCA has power to make temporary or permanent product intervention rules prohibiting firms from engaging in certain types of conduct, including prohibiting entering into specified agreements with any person or specified person or doing so unless meeting specified requirements.

International Commentary

International commentary on FCP also reflects an increasing focus on PDD issues. For example, the G20 High-Level Principles for Digital Financial Inclusion, issued in 2016, emphasize the need for consumer-centric product design approaches as a means of promoting digital financial inclusion, noting the need to

[e]ncourage industry . . . to adopt customer-centric product design approaches that focus on customer needs, preferences and behaviours and facilitate the uptake and usage of digital financial services among the financially excluded and underserved.¹³

The World Bank's recently published Good Practices for Financial Consumer Protection notes that product regulation is an emerging area of regulation beyond product suitability and includes requiring that the product design process ensures good consumer outcomes. The authors explain the following:

Product regulation [includes] . . . requiring that the product design process ensures good consumer outcomes . . . [which] consists of regulatory requirements regarding the efficacy of product oversight and governance by financial service providers and covers the whole product cycle from research to post-sales, with the objective of producing fair outcomes for consumers in general—that is, not for a specific consumer. This approach could give clearer means for the supervisory authority to take action when unsuitable products are introduced in the market or offered to a particular consumer, even where there are no regulatory prohibitions on a specific practice or product.¹⁴

The first of the Smart Campaign's Client Protection Principles (focusing on microfinance) addresses product design and delivery issues, stating the following:

Appropriate product design and delivery
Providers will take adequate care to design products and delivery channels in such a way that they do not cause clients harm. Products and delivery channels will be designed with client characteristics taken into account.¹⁵

Six core elements of appropriate product design and delivery are discussed in the Smart Campaign's Detailed Guidance on the Client Protection Principles.¹⁶ The core elements include, among others, suitable product design, suitable product delivery, and product simplicity.

A model law developed by the Smart Campaign to provide a model legal framework for FCP contains provisions concerning product risk management. These provisions

require that processes and procedures at the provider level:

- identify and control product risks across the value chain, including in the development and distribution phases;
- set out a product design and pricing philosophy; and
- define target clients and the process for authorization and introduction of new consumer products and services.¹⁷

5. COMMON APPROACHES IN PDD REGULATION FOR RETAIL BANKING PRODUCTS

A number of common approaches regarding the scope and elements of PDD regulatory frameworks for retail banking products can be observed from the regimes considered in this Discussion Note. These approaches relate to the following:

- The policy aims of PDD regulation
- The coverage (in terms of both products and providers) and application of PDD regulation
- Requirements for governance arrangements
- Requirements for target market assessments
- Requirements for product testing
- Distribution requirements
- Requirements for post-sale product reviews

When considering how such approaches may be implemented by any jurisdiction, it is important to keep in mind that PDD regulation is a relatively new field, particularly in relation to retail banking products. Country context also matters. PDD regulatory frameworks will need to be appropriately adapted for each country. For example, a country seeking to introduce PDD rules within a nascent FCP legal framework may need to start with some simpler requirements.

Focus and Objectives of PDD Regulation

The main focus of PDD regulation is to require FSPs to put in place POG arrangements designed to ensure that financial products meet the needs of consumers in target markets or market segments. The long-term objective of such rules is to encourage fair treatment and trust in the financial system. For example, when Australia's recently introduced PDD rules were first proposed, their stated objectives were the following:

13. Organisation for Economic Co-operation and Development 2011, page 8 (guidance on Principle 1).

14. World Bank Group 2017, Chapter 1, Section C4, page 39.

15. Smart Campaign 2015. For an example of the implementation of this principle, see Smart Campaign 2012.

16. Smart Campaign 2011.

17. Smart Campaign 2015, pages 20–21.

- Reduce the number of consumers buying products that do not match their needs, and reduce consequent significant consumer detriment.
- Promote fair treatment of consumers by firms that design and distribute financial products.
- Promote efficiency and limit or avoid the future need for more prescriptive regulation.
- Build confidence and trust in the financial system.¹⁸

The EU's new PDD rules for retail banking products introduced in the EBA Guidelines are intended to

deal with the establishment of product oversight and governance arrangements for both manufacturers and distributors as an integral part of the general organisational requirements linked to internal control systems of firms. . . . They establish procedures relevant for ensuring the interests, objectives, and characteristics of target markets are met.¹⁹

Key Principles Relating to Scope and Coverage of PDD Regulation

PDD regulatory frameworks for retail banking products tend to reflect the following baseline principles, although not all elements are found in all examples:

- **Apply rules to issuers, manufacturers, and distributors:** PDD rules tend to be applied to (i) product issuers who design products and distribute them in their own name or that of a third party (under a "white-label arrangement") (in each case, the issuer has the contractual relationship with the end customer); (ii) product manufacturers who design products for one or more third-party issuers (that is, they have no contractual relationship with the end customer);²⁰ and (iii) third-party distributors of products.²¹
- **Focus on customer needs:** PDD rules focus on the need for financial products to be designed, marketed, and distributed so they meet consumer needs and capabilities. Providers are required to place increased focus on what target consumers want and need, rather than only on what products can be sold to consumers with a view to maximizing profits.
- **Take a proportional approach:** The onerousness of POG obligations (that is, the practical compliance burden on FSPs) should be proportional to the nature, scale, and complexity of both the business of the relevant institution and the product in question.²²
- **Cover both simple and complex products:** Of the case studies reviewed for this Discussion Note, none makes a specific distinction between applying PDD rules to simple products such as basic banking, credit, and accounts and applying them to more complex products. Rather, the common view tends to be that a proportional or scalable approach to the application of the PDD rules should ensure that compliance for simple products is more straightforward and feasible to apply by all FSPs.²³
- **Cover "consumers":** PDD rules are generally confined to products offered to a "consumer" (or its equivalent term), as with other FCP rules. As a result, while individuals are always covered, sometimes coverage is limited to individuals acquiring products for nonbusiness purposes, such as in the case of the EBA Guidelines. However, sometimes PDD rules also apply to products sold to smaller businesses. This is the case with the new Australian PDD legislation as well as the COFI Bill in South Africa. Further, although the EBA Guidelines currently apply only to individual consumers, the Guidelines state that competent authorities may wish to consider extending the protections of the Guidelines to microenterprises and small and medium-sized enterprises.²⁴
- **Consider implementation and compliance costs:** As noted in the Australian Government's paper that proposed its PDD reforms²⁵ (DDO Proposals Paper), it is important that a PDD framework not impose unnecessary implementation and compliance costs.²⁶ This is also reflected in the proportionality aspect of PDD rules noted above.

Requirements for Product Governance Arrangements

A core element of PDD frameworks is the obligation of regulated entities to establish and implement clear, docu-

18. Australian Government the Treasury 2014, page 199.

19. EBA Guidelines, para. 5.

20. It may be the case, however, that a product manufacturer is not within the mandate of the financial system regulator.

21. See, for example, EBA Guidelines, para. 6.

22. See, for example, EBA Guidelines, guidelines 1.5 and 9.1, and COFI Bill, section 48(3).

23. See, for example, Sourcebook 3.1.2R-3.1.3G.

24. EBA Guidelines, para. 8.

25. Australian Government the Treasury 2016.

26. Australian Government the Treasury 2016, page 8.

mented POG arrangements. Though framed differently in different countries, these obligations typically require that such arrangements are designed to ensure a consumer centric PDD process for the entire product life cycle. For example, the EBA Guidelines state the following:

The manufacturer should establish, implement and review effective product oversight and governance arrangements. The arrangements should aim, when products are being designed and brought to the market, (i) to ensure that the interests, objectives and characteristics of consumers are taken into account, (ii) to avoid potential consumer detriment and (iii) to minimise conflicts of interest.²⁷

The case studies also include supporting requirements for mandated governance arrangements, such as

- having clearly articulated internal roles and responsibilities;
- requirements for senior management and all relevant functional areas (including legal and compliance) to be involved in the decision-making process;
- requirements for the board or equivalent governing body to sign off on the final product design; and
- a requirement for consultation with key stakeholders, including target consumer groups and industry and proposed distributors.

Requirements for Target Market Assessments

Another core element of PDD regulatory frameworks is the need for an assessment of the target market when a product is being developed. The target market is generally described as the group(s) of consumers for whom a particular product is intended by the issuer or manufacturer.²⁸ Key requirements include the following:

- **Identify the target market and then consider its profile:** What should be considered in determining the profile of a target market varies but often includes factors such as the needs, objectives, characteristics, or situations of customers within the target market. For example, the EBA Guidelines refer to “the interests, objectives and characteristics of the identified target

market(s)” and the related need to assess the “financial capability” of the target market,²⁹ and the Australian legislation refers to the “likely objectives, financial situation and needs” of retail client(s).³⁰ The UK’s rules refer to the “identified needs, characteristics and objectives” of the target market.³¹ The COFI Bill simply requires that appropriate steps be taken to identify the consumers to whom products are targeted and that the financial institutions satisfy themselves that the products are “appropriate” to their “needs.”³²

- **Assess whether the product is suitable for its target market:** Such assessments should take into account factors such as product features (including whether it is complex or simple), risks, and, sometimes, charges. The focus with regard to charges seems to be on requiring financial institutions to bring to the market products with charges that suit the target market profile,³³ rather than to mandate specific requirements as to the level of the fees and charges. For example, the EBA Guidelines refer to the need to take “charges” into account in a target market assessment.³⁴ Such an approach could be a more practical and flexible alternative to policy makers mandating the permissible levels of fees and charges, a blunter and less targeted policy approach.³⁵

PDD regulatory frameworks also tend to include procedural requirements regarding target market assessments. For example, assessments may be required to be in writing; describe the relevant class of clients (including clients not within the target market); describe the distribution arrangements; specify the review period and trigger for review; and be updated as necessary from time to time. Assessment reports may also be required to be publicly available free of charge. There are also requirements that records be kept of all decisions in relation to the assessment.³⁶

However, PDD regulatory frameworks tend not to describe how a target market should be defined beyond the general elements discussed above, seemingly leaving this matter to FSPs. For example, the case studies considered in this Discussion Note generally did not include express

27. EBA Guidelines, guideline 1.1. See also guideline 9.1 for distributors.

28. See, for example, EBA Guidelines’ definition of a “target market” at para. 15: “The group or groups of end consumers for whom the product is designed, as intended by the manufacturer.”

29. EBA Guidelines 3.2 and 3.6.

30. Corporations Act, section 994B(8)(b), as inserted by the DDO Act.

31. FCA Sourcebook, para. 3.2.10.

32. COFI Bill, section 49(1)(b).

33. See, for example, Sourcebook 3.2.14R.

34. EBA Guidelines, section 3.3.

35. For a discussion of issues with interest rate caps, see Ferrari, Masetti, and Ren 2018. Case studies discussed in the paper indicated that, while some forms of interest rate caps can indeed reduce lending rates and help to limit predatory practices by formal lenders, interest rate caps often have substantial unintended side effects.

36. Corporations Act, sections 994B and 994F, as inserted by the DDO Act; Sourcebook 3.2.8R–3.2.10R; and EBA Guidelines, guidelines 1.1–1.4 and 9.1–9.3.

requirements on defining a target market by reference to geographic, demographic, or socioeconomic factors. Additional expectations, however, could be set by regulators through guidance. For example, the EBA, in its final report leading up to the introduction of the EBA Guidelines, referred to “good practice examples” for compliance with target market assessment requirements that included demographic factors.³⁷

Requirements for Product Testing

Product testing may also be part of the required product design processes contemplated by PDD regulatory frameworks. Depending on the complexity of a product, it may be required to be piloted, and even stress tested, with a view to identifying how the product might perform in a variety of market environments and assessing how customers will be affected.³⁸

For example, under the EBA Guidelines, manufacturers have product testing obligations that must be fulfilled before the product can be brought to market. This includes obligations relating to new products, existing products introduced to new target markets, and existing products to which significant changes have been made. A manufacturer is expected to conduct product testing to assess how the product would affect its consumers under a wide range of scenarios, including stressed scenarios.³⁹ The nature and level of any required testing, however, would depend on the complexity of the product and level of potential risk for the consumer.⁴⁰

In the UK, manufacturers must undertake a scenario analysis for structured deposits to assess the risk of poor outcomes for end clients and the circumstances in which those risks might occur.⁴¹ They must also consider whether the financial instrument may represent a threat to the stability of financial markets. In conducting the scenario analysis, manufacturers must assess their financial instruments under negative conditions. The Sourcebook provides an illustrative list of such conditions, including where the market environment deteriorates, where the manufacturer experiences financial difficulties, and where demand for the instrument is much higher than anticipated.

Distribution Requirements

PDD frameworks tend to include a range of obligations on product issuers/manufacturers in relation to their distribution arrangements for a product. Key obligations include the following:⁴²

- Distribution channels and distributors should be appropriate for consumers in the target market for the product.
- Distributors should be provided with the target market assessment and clear and appropriate information as to the target market, product features, risks, and fees and charges to be paid by the consumer.
- Issuers should conduct due diligence on distributors and continuously monitor their activities.
- Issuers should obtain ongoing and frequent feedback from distributors over the product life cycle, including about perceived product risks and events that should trigger reviews.
- The risks of conflicts of interest should be minimized. This includes conflicts arising from any remuneration or commissions to be paid to distributors.
- Issuers should take appropriate action when they have concerns about distribution arrangements (for example, by ceasing to use a distribution channel or a particular distributor).
- If either the issuer or distributor outsources all or part of their regulated activities, then they should comply with any separate rules on outsourcing, including retaining responsibility for the activities of the entity to which the activities were outsourced.

PDD frameworks also impose a range of obligations on distributors with regard to distribution activities.⁴³ Examples of key obligations include the following:

- Distributors (including staff and any agents) should distribute the product consistently with the target market assessment and any other information or advice provided by the issuer.
- Distributors should sell products outside the target market only with specific approval of the issuer.

37. EBA 2015, page 73.

38. For a practical discussion on testing, see, for example, Consultative Group to Assist the Poor 2016.

39. EBA Guidelines, guideline 4.

40. EBA Guidelines, guideline 1.5.

41. Sourcebook, 3.2.12R–3.12.13R.

42. EBA Guidelines, guidelines 7–8 and Part 6, “Outsourcing”; Sourcebook 3.2.16–3.2.183; Corporations Act, sections 994E and 994F, as inserted by the DDO Act; and COFI Bill, sections 48 and 49.

43. EBA Guidelines, guidelines 9–12; Sourcebook, Chapter 3.3; Corporations Act, sections 994E and 994F, as inserted by the DDO Act; and COFI Bill, sections 48 and 49.

- Distributors may themselves be required to undertake a target market assessment.
- In agreeing to work with an issuer, distributors need to consider the reliability of that issuer from the perspective of the end clients. Distributors thus may have their own due diligence obligations.
- Distributors need to understand the financial products they distribute and the related markets.
- Distributors should establish and implement effective POG arrangements that are specific and proportionate to their size and role.
- Distributors should have staff and agent-training processes and procedures.
- Distributors should collect information to assist the issuer with their product review responsibilities.
- Distributors should advise the issuer of any concerns regarding the suitability of the marketing of the product and if any review triggers have arisen.

Note that a number of the above requirements, such as those regarding managing conflicts of interest, are already typically covered in existing regulation, although the focus here would be on aspects relevant to PDD.

Requirements for Post-Sale Product Reviews

Following product launch, the issuer (in consultation with third-party distributors and other key stakeholders) may be required periodically to review the product and related disclosure materials. The aim is to assess whether the product still meets the needs of the target market and to identify possible follow-up actions (for example, to modify or withdraw the product or provide an exit strategy for customers). Such reviews are likely to take place more frequently when a product is still new or when there are market changes (such as significant changes in variable interest rates on consumer credit products).⁴⁴

Potential tools for conducting post-sale reviews for retail banking products might include consumer surveys and focus groups; reviews of complaints data; advice from distributors; sales figures; analysis of distributors' sales lists; and mystery shopping exercises.

6. PRODUCT INTERVENTION POWERS

The case studies examined for this Discussion Note often include product intervention regimes that apply to some or all retail banking products alongside PDD rules. This section highlights key trends in the makeup of such regimes.

What Is Meant by Product Intervention Powers

PDD regimes may be supported by product intervention powers for regulators. Product intervention powers in this context refer to regulators' powers to impose temporary or permanent restrictions on the offer of retail banking products by FSPs. Several of the jurisdictions discussed in this Discussion Note have introduced such powers. Importantly, product intervention powers in this context do not refer to rules that require preapproval of products by regulators.

Scope and Range of Powers

The types of products over which regulators are granted product intervention powers vary. For example, in Australia, ASIC has been given product intervention powers over a broad range of financial products, including banking products and consumer credit products.⁴⁵ On the other hand, the EU's regime gives EU agencies and domestic regulators of Member States powers over a limited set of products, such as structured deposits.⁴⁶ However, domestic legislation in individual Member States can provide for broader coverage. For example, in the UK, product intervention powers granted to the FCA extend to financial products more broadly.⁴⁷

The range of interventions that regulators can undertake tends to be relatively broad. Where a regulator is given such powers, provisions tend to give a fair amount of flexibility in structuring an intervention. For example, domestic regulators and the EBA are given powers under EU legislation to temporarily prohibit or restrict marketing, distribution, or sale of specific structured deposits or structured deposits with specific features, or to temporarily prohibit or restrict a type of financial activity or practice.⁴⁸ Proposed powers for the FSCA in South Africa include the power to prescribe conduct standards relating to, among other things, the prohibition of or restrictions

44. See, for example, EBA Guidelines, guidelines 5, 6, 12.3, and 12.4; Sourcebook, 3.2.19R; Corporations Act, section 994E, as inserted by the DDO Act; COFI Bill, sections 50 and 65(6).

45. New Part 7.9A of the Corporations Act 2001 (Cth) (Corporations Act) and Part 6–7A of the National Consumer Credit Protection Act 2009 (Cth) (National Credit Act), as inserted by the DDO Act.

46. MiFIR, Articles 41–42.

47. FSMA, section 137D.

48. MiFIR, Articles 41–42.

on the offer of products to certain types of customers.⁴⁹ The UK's FCA similarly has the power to make product intervention rules that, among other things, prohibit entering into specified agreements (for example, a contract for the sale of a product) with any person or any specified person or doing so unless meeting specified requirements.⁵⁰

Timeframes and Process Requirements

Regulators generally have greater autonomy or flexibility in relation to product interventions that last for a limited period. For example, ASIC may make product intervention orders that last up to 18 months (or other prescribed periods). Orders that last longer require ministerial approval. If the UK's FCA wishes to make permanent product intervention rules, it must follow a general legislative rule-making process contemplated in the overarching legislation, rather than the more streamlined, customized process specified for temporary interventions.

Requirements to consult with stakeholders and notify them in advance will frequently apply. For example, ASIC must consult with persons affected by a proposed product intervention order (and, where relevant, the prudential regulator) before making the order. The EBA must notify relevant competent authorities in Member States and publish in advance on its website notices to take product intervention action.

Regulators will generally need to consider a number of factors relating to affected consumers, stakeholders, and the market when deciding whether, and how, to exercise their product intervention powers. These include, for example, the nature and extent of the potential detriment to relevant consumers, the size of potential financial losses or of the relevant segment, and whether the proposed intervention is proportional to the potential harm.

7. AREAS OF FUTURE RESEARCH AND ANALYSIS

As previously noted, many jurisdictions are still in the process of considering, developing, or implementing PDD rules, and there is much scope for further research on these topics. There is also currently a lack of long-term experience with supervising and enforcing such requirements and a lack of evidence assessing their impact. As the experience and evidence base grows, there will be more information to draw from to develop effective, well-tested PDD approaches.

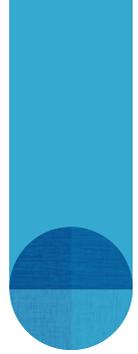
Possible areas of further research include the following:

- **Guidance from and for supervisors:** This research could encompass guidance from supervisors in jurisdictions that have PDD rules and product intervention powers as to their experiences, and also guidance for supervisors on issues such as how compliance with principles based PDD rules should be assessed.
- **Analysis of target markets:** Research on what quantitative and qualitative research approaches and tools can be used for target market assessments could be helpful, together with recent examples of good industry practice.⁵¹
- **Assessing the impact of PDD regulatory frameworks:** In the longer term, and as experience with these rules develops, it could be helpful to conduct rigorous impact assessments of how effective they are in practice, as well as their impact on innovation and on the makeup of the financial sector.

49. COFI Bill, section 51(2).

50. FSMA, section 137D.

51. For an example of such research, see Consultative Group to Assist the Poor 2016, page 12.



COUNTRY CASE STUDIES

AUSTRALIA

Australia recently passed legislation introducing a new PDD framework. The new framework was introduced through the DDO Act, which amends, among other laws, Australia's Corporations Act, generally regulating financial products other than consumer credit, and the National Credit Act, regulating consumer credit. (As discussed

below, however, the amendments to the latter relate only to product intervention powers; consumer credit is otherwise excluded from PDD requirements.) The new PDD rules will be supported by regulations to be made under the DDO Act that are currently in draft—the Draft DDO Regulations.

KEY TERMS

SOURCE/LEGISLATION	KEY TERM	DEFINITION
Corporations Act, section 994A as inserted by DDO Act	Regulated person	<p>A regulated person in relation to a financial product means</p> <ul style="list-style-type: none"> the seller of the financial product, if the seller is required to make disclosures under sections 707 or 1012C of the Corporations Act; or a regulated person as defined in section 1011B of the Corporations Act, being <ul style="list-style-type: none"> the issuer of a financial product; any person required to hold a financial services licence (or who is exempt from holding such a licence by a specified provision); any authorised representative of a licensee; and sellers of financial products where the sale requires a disclosure document or 'Product Disclosure Statement' (the Corporations Act contains an extensive regime regulating the form and content of Product Disclosure Statements); or a person prescribed by the regulations. Under regulation 7.8A.01 of the Draft DDO Regulations this includes <ul style="list-style-type: none"> the offeror, where the sale amounts to an indirect issue by the offeror; the offeror, where the sale amounts to an indirect off-market sale by the controller of the issuer; and product distributors (defined by section 910A⁵² of the Corporations Act as authorised representatives of a financial services licensee) in relation to basic deposit products, general insurance products, and bundled consumer credit insurance products.
Corporations Act, section 994B as inserted by DDO Act	Persons who must make a target market determination	<p>A person must generally make a target market determination for a financial product if</p> <ul style="list-style-type: none"> the person is required to prepare a Product Disclosure Statement for retail clients for the product (or in the case of securities, a disclosure document for investors). This is generally the issuer of the product; or the regulations otherwise require them to do so. <p>Some products (generally not being retail banking products) are excluded from the requirement to make a target market determination, namely</p> <ul style="list-style-type: none"> a MySuper product (that is, an accumulation fund having certain prescribed characteristics); a margin lending facility; a security issued under an employee-share scheme;

52. As modified by ASIC, Corporations (Basic Deposit and General Insurance Product Distribution) Instrument 2015/682.

KEY TERMS, *continued*

SOURCE/LEGISLATION	KEY TERM	DEFINITION
		<ul style="list-style-type: none"> • a fully paid ordinary share in a company or a foreign company (except in certain limited circumstances); • a financial product issued or offered for regulated sale by an exempt body or an exempt public authority; or • a financial product of a kind prescribed by the regulations.
Corporations Act, sections 994A and 994B as inserted by DDO Act	Target market determination	<p>A determination that (in summary)</p> <ul style="list-style-type: none"> • describes the class of retail clients that comprises the target market for a relevant product; • specifies any conditions and restrictions on retail product distribution conduct in relation to the product (except as already mandated by the legislation); and • specifies events and circumstances that would reasonably suggest that the determination is no longer appropriate. <p>(The determination must also meet various other content and process requirements specified in the legislation.)</p>
Corporations Act, section 761E	Issuer of a financial product	The issuer, in relation to a financial product issued to a person (the client), is the person responsible for the obligations owed under the terms of the product to the client or a transferee or a person nominated by either of these.
Corporations Act, sections 761G and 761GA	Retail client	A product is taken to be provided to a person as a retail client unless sections 761G (5), (6), (6A), or (7) or section 761GA provide otherwise. Examples of exclusions from coverage include (in summary) a product that is provided to a business that is not a “small business” as defined or provided to certain wholesale and professional investors. A small business means a business employing fewer than 100 people if it is a manufacturing business or otherwise fewer than 20 people.

Who Must Comply

The design obligations introduced by the DDO Act are intended to apply primarily to a person who is responsible for developing the financial product. This person is also described in the final Explanatory Memorandum for the legislation⁵³ (DDO Bill Explanatory Memorandum) as “the person who is responsible for preparing the disclosure document.”⁵⁴ This is generally the issuer of a product but in some prescribed circumstances includes a different person acting as a seller.

The design rules under the DDO Act comprise several key obligations. These are discussed in further detail below. The DDO Bill Explanatory Memorandum summarizes these obligations as

- to make a publicly available target market determination;
- to review the target market determination as required to ensure it remains appropriate;
- to keep records of the person’s decisions in relation to the new regime; and

- to notify ASIC of any significant dealings in a product that are not consistent with the product’s target market determination.⁵⁵

The distribution obligations introduced by the DDO Act apply to a regulated person (as discussed under “Key Terms”) when they engage in retail product distribution conduct. The term retail product distribution conduct refers to dealing in the product with a retail client, giving a prescribed product disclosure document to a retail client, and providing financial product advice regarding the product to a retail client.⁵⁶ This would include, for example, issuers who distribute their own product as well as third-party distributors and financial advisers.

The distribution rules under the DDO Act also comprise several key obligations. These are discussed in further detail below. They include (in summary) obligations not to engage in retail product distribution conduct unless an appropriate target market determination is in place; to take reasonable steps to act consistently with the determination; to collect information and complaints data required by the issuer; and to notify the issuer of any significant dealings that are not consistent with the determination.⁵⁷

53. Treasury Laws Amendment (Design and Distribution Obligations and Product Intervention Power) Bill, 2018 (Cth) Revised Explanatory Memorandum.

54. DDO Bill Explanatory Memorandum, 1.46.

55. DDO Bill Explanatory Memorandum, 1.42.

56. Corporations Act, section 994A(1), as inserted by the DDO Act.

57. DDO Bill Explanatory Memorandum, 1.43.

The DDO Act design and distribution obligations apply to products provided to retail clients. As noted under “Key Terms,” a retail client can include certain small businesses.

Affected Products

The design and distribution obligations in the DDO Act generally apply to financial products for which a disclosure document must be prepared under the Corporations Act.⁵⁸ A financial product is defined as a facility through which, or through the acquisition of which, a person does one or more of the following:

- Makes a financial investment
- Manages financial risk
- Makes noncash payments.⁵⁹

In addition, a wide range of products are specifically included in the concept of a financial product (such as, for example, deposit facilities provided by authorized deposit-taking institutions).⁶⁰

Financial products relevantly include, for example, deposit and payment products. The design and distribution obligations, however, do not apply to (among others) credit products, although the product intervention powers discussed further below do. The DDO Bill Explanatory Memorandum indicates that consumer credit products were intentionally excluded because they are already subject to specific rules under the National Credit Act, such as those concerning responsible lending, aimed at ensuring product appropriateness.⁶¹ As discussed earlier in this Discussion Note, it is not clear that product suitability requirements are necessarily a substitute for PDD requirements. It is notable, however, that the new rules are proposed to apply to “basic banking products”⁶² (which include deposit products that meet prescribed criteria, as well as payment facilities), even though such products are exempt from some existing FCP requirements due to their perceived lack of complexity or risk.

The obligations generally apply to offers of financial products that require disclosure in the form of a Product Disclosure Statement under the Corporations Act.⁶³ This approach is stated to have been taken in part to address the

shortcomings of the existing disclosure regime.⁶⁴ By way of further context, the DDO Bill Explanatory Memorandum includes the following explanation:

The Corporations Act relies heavily on disclosure to assist consumers understand and select appropriate financial products. However, disclosure can be ineffective for a number of reasons, including consumer disengagement, complexity of documents and products, behavioural biases, misaligned interests and low financial literacy. The availability of financial advice may not be sufficient to overcome these issues. A consumer may not seek financial advice or may receive poor-quality advice.

The Financial System Inquiry recognised these shortcomings of the existing disclosure regime. In response, it recommended the introduction of a targeted and principles-based product design and distribution obligation. The Government accepted this recommendation.⁶⁵

Key Requirements for Issuers/Manufacturers and Distributors

Governance arrangements

Governance arrangements have not been expressly provided for in the DDO Act. The DDO Proposals Paper that preceded the legislation stated that, in relation to distributor obligations

[i]mplementation of these proposals could form part of a broader governance framework put in place by financial firms that sets out their internal policies and procedures in relation to the design, distribution and review of products, including training, monitoring and operational controls to ensure business practices are compliant.⁶⁶

Nevertheless, there is no express legislative obligation to do this. However, it should be noted that financial services licensees are more generally subject to license conditions imposed by ASIC under the Corporations Act requiring them to establish and maintain compliance measures in relation to financial services laws.⁶⁷

Target market assessments

A target market determination must meet requirements regarding its effectiveness in ensuring the suitability of products sold to retail clients. Specifically, the assessment must be such that it would be reasonable to conclude that

58. DDO Bill Explanatory Memorandum, 1.14.

59. Corporations Act, section 763A.

60. Corporations Act, section 764A.

61. DDO Bill Explanatory Memorandum, 1.21.

62. Draft DDO Regulations, regulation 7.8A.02.

63. DDO Bill Explanatory Memorandum, 1.18.

64. DDO Bill Explanatory Memorandum, 1.20.

65. DDO Bill Explanatory Memorandum, 1.2–1.3.

66. Australian Government the Treasury 2016, pages 17 and 23.

67. ASIC, *Pro Forma 2019—Australian Financial Services Licence Conditions* (2019), page 4.

- if the product were sold to a retail client in accordance with the distribution conditions and restrictions specified in the determination, it would be likely that the retail client would be in the target market; and
- further, if the product were sold to a retail client in the target market, it would be likely that the product would be consistent with the client's objectives, financial situation, and needs.⁶⁸

The DDO Bill Explanatory Memorandum provides examples of factors to be taken into account in determining whether a product is likely to be consistent with target clients' likely objectives, financial situations, and needs, including the following:

- The key features of the product, including its complexity, risk profile (over the lifetime of the product), any applicable fees, and the investment needs that the product is seeking to meet.
- The circumstances of persons within a particular market, such as their understanding of product features, capacity to meet financial obligations or bear losses, and whether their investment needs are the same as those the product seeks to meet.⁶⁹

A target market determination must also meet other specific requirements. They include (in summary) that the determination have the following characteristics:

- It is in writing.
- It is freely and publicly available.
- It describes the class of retail clients that comprise the target market for the product.
- It specifies any conditions or restrictions on the product distribution.
- It specifies events and circumstances ("review triggers") that could reasonably determine that the determination is no longer appropriate. These triggers will vary from product to product. As noted in the DDO Bill Explanatory Memorandum, they might include, for example, an event or circumstances that would materially change a factor taken into account in making the target market determination; whether the product is being distributed and purchased as envisaged; and, importantly, the nature and extent of any feedback from those who distribute or acquire the product.⁷⁰

- It specifies details of the timing of reviews of the determination (such timing having to be reasonable).⁷¹

Product design and testing requirements

The DDO Act does not impose specific requirements in relation to the product design process. However, as discussed above, a target market determination must meet general requirements as to its effectiveness in ensuring the suitability of products sold to retail clients. This obligation, particularly as it relates to the client's needs, thus in turn informs the product design process. The DDO Bill Explanatory Memorandum explains that retail clients' likely objectives, financial situations, and needs to be taken into account when determining a product's target market are important for good product design.⁷² Though not expressly required by the DDO Act, the Proposals Paper adds that during the product design phase

where the nature of the product warrants it, issuers should stress-test the product to assess how consumers may be affected in different circumstances. They should also consumer-test products to make key features clear and easy to understand.⁷³

Distribution requirements

A person who makes a target market determination and a person who engages in retail product distribution conduct must take reasonable steps that will, or are reasonably likely to, result in retail product distribution conduct being consistent with the determination. However, the person will not be taken to commit an offence merely because another regulated person's conduct is inconsistent with the determination, or because a retail client outside the target market acquires the product. (Exceptions have also been included to allow for effective provision of personal advice, which is subject to a separate regime under the Corporations Act.)⁷⁴

The DDO Proposals Paper notes that some product issuers expressed concerns about any expectation that under the new rules they would be indirectly accountable for the conduct of external distributors. In response, the Proposals Paper states that, in general, distributors will have direct responsibility for putting controls in place to ensure that products are distributed in line with the terms of the determination. However, product issuers cannot be willfully blind to distributors who act inconsistently with issuers' expectations.⁷⁵

68. Corporations Act, section 994B(8), as inserted by the DDO Act.

69. DDO Bill Explanatory Memorandum, 1.59.

70. DDO Bill Explanatory Memorandum, 1.62.

71. Corporations Act, sections 994B(5)–(9), as inserted by the DDO Act.

72. DDO Bill Explanatory Memorandum, 1.58.

73. Australian Government the Treasury 2016, page 49.

74. Corporations Act, section 994E, as inserted by the DDO Act. See also DDO Bill Explanatory Memorandum, 1.84 and 1.105.

75. Australian Government the Treasury 2016, page 22. Also see DDO Bill Explanatory Memorandum, 1.101.

Some guidance is given regarding what steps are reasonable in this context. Matters to be taken into account in determining what is reasonable are stated to include the following (in summary and without limitation):

- The likelihood of any particular distribution conduct being inconsistent with the determination
- The nature and degree of harm that might result from the sale or issue of the product inconsistently with the determination
- What the distributor or issuer (as relevant) knows or ought to know about the likelihood of inconsistency, the nature and degree of harm, and ways of eliminating and minimizing the likelihood and the harm
- The availability and suitability of ways to eliminate or minimize the likelihood and the harm.⁷⁶

The Proposals Paper offers further guidance, stating that distributors ought to have reasonable controls in place to act in accordance with the expectations of the product issuer. It contemplates that controls should be agreed upon by the issuer and distributor, and that some controls may even be developed by the issuer. When a control will be reasonable will depend on the type of product, the distribution strategy, and other relevant circumstances. Examples of controls provided by the Proposals Paper include the following:

- Short, targeted warnings to consumers at key decision-making points
- Ensuring information is delivered to consumers (such as through scripts or by using prerecorded audio or video)
- Tools to help consumers understand/decide, such as calculators or self-assessment tools
- Requiring choice—for example, though an opt-in distribution model
- Staff competency, such as through training
- Supervision, meaning management oversight, audits, or reviews of distribution practices to ensure that staff follow relevant procedures
- Using customer information that the distributor can reasonably access—for example, where the distributor provides other services to the consumer
- Encouraging consumers to access personal advice.⁷⁷

Distributors are also restricted from distributing products for which no target market determination has been made.⁷⁸ Distribution must not be undertaken in these circumstances unless the distributor believes on reasonable grounds that the determination has been made or is not required.

Product review requirements

Target market reviews must be conducted periodically, consistently with the period for such reviews and the review triggers specified in the relevant determination. On becoming aware of a review trigger or other relevant circumstances indicating the determination may no longer be appropriate, distribution of the product must cease as soon as practicable and otherwise within 10 business days unless a review has been conducted and a new target determination has been made, if required (or another exception applies). The person responsible for making, and reviewing, a determination (as noted above, usually the product issuer) must also inform distributors of their obligation to cease distribution of the product, and they must then cease distribution.⁷⁹

The DDO Proposals Paper describes factors that are to be considered during a review. They include any consumer feedback about the product, details of any complaints, feedback from product distributors, claims outcomes, and profit margins, all of which inform whether the product is operating as expected.⁸⁰ Although such factors have not been expressly set out in the DDO Act, they are contemplated to some extent. This is the case, for example, through

- the provisions that require target market determinations to specify information about review triggers;⁸¹ and
- recordkeeping and reporting obligations relating to complaints, review triggers, the matters required to be covered by the target market determination, and the steps taken to comply with it.⁸² Obligations apply to both the maker of the target market determination and other regulated persons (including distributors).

If a regulated person (such as a distributor) becomes aware of a significant dealing inconsistent with a target market determination, they must report the dealing to the maker of the target market determination.⁸³ Further, if the maker of a target market determination becomes aware of such a dealing, they must report it to ASIC. If issuers become aware of significant dealings in the product in relation to a retail client, they are required to inform ASIC

76. Corporations Act, section 994E(5), as inserted by the DDO Act.

77. Australian Government the Treasury 2016, page 24.

78. Corporations Act, section 994D, as inserted by the DDO Act.

79. Corporations Act, section 994C, as inserted by the DDO Act.

80. Australian Government the Treasury 2016, page 22.

81. Corporations Act, section 994B(5)(d), as inserted by the DDO Act.

82. Corporations Act, section 994F, as inserted by the DDO Act.

83. DDO Act, section 994F(6).

in writing within 10 business days if those dealings are inconsistent with the determination.⁸⁴

Applicable Penalties

Retail clients have recourse rights following a breach of the new provisions. In particular, they may recover loss or damages for relevant contraventions. This is regardless of whether the person in breach has been convicted of a relevant offense, a court has made a declaration of contravention, or a court has ordered anyone to pay a penalty in relation to the contravention. Courts may also make orders voiding contracts, orders for the return of money paid, and orders for the payment of interest in connection with a breach.⁸⁵

Civil and criminal penalties may also apply. For example, there are penalties for failures to

- make a target market determination before any person engages in distribution conduct;
- make determinations available to the public free of charge;
- complete a review of a determination during the review period;
- refrain from distributing a product when its determination has ceased to be appropriate or has not been made;
- take reasonable steps to ensure consistency with target market determinations;
- keep complete and accurate records; and
- make reports.

Penalties include fines up to \$A200,000 for individuals and \$A1 million for corporations per breach and imprisonment up to five years, depending on the offense.

Product Intervention Powers

The DDO Act makes provision for ASIC to have product intervention powers. This will be achieved through the introduction of new Part 7.9A in the Corporations Act and an equivalent Part 6-7A in the National Credit Act. The object of these powers is to provide ASIC with powers

that it can use proactively to reduce the risk of significant detriment to retail clients resulting from financial products.⁸⁶ ASIC's product intervention powers will cover credit products regulated by the National Credit Act⁸⁷ as well as the broad range of financial products covered by the Corporations Act.

To make a product intervention order, ASIC must be satisfied that a financial product has resulted, or will or is likely to result, in significant detriment to relevant clients.⁸⁸ If so, an individual order can be made to the effect that a person must not engage in specified conduct in relation to the product, either entirely or except in accordance with specified conditions.⁸⁹ (ASIC can also make a market-wide product intervention order in relation to an entire "class" of products, but such an order must be made as a "legislative instrument" and would change some of the requirements discussed here.) The conditions specified by a product intervention order can include, for example, a condition prohibiting the issue of a product to a retail client unless the client has received personal advice. However, ASIC cannot make orders specifying certain conditions, including specifying that a person satisfy a standard of training other than standards prescribed by (as applicable) the Corporations Act or National Credit Act.

ASIC must consider the following non-exhaustive list of factors in determining whether there has been or will be a "significant detriment" to relevant clients:

- The nature and extent of the detriment
- The actual or potential financial loss to the clients
- The impact that the detriment has had or will have on the clients
- Any other matters prescribed by the regulations.⁹⁰

ASIC must consult with persons and statutory bodies that are affected by the order before making it. However, the requirement to consult with persons (rather than statutory bodies) will be taken to have been complied with if ASIC makes the order or a description of the order available on its website and invites the public to comment. Further, a failure to comply with the consultation requirement does not invalidate a product intervention order.⁹¹

84. DDO Act, section 994G.

85. Corporations Act, sections 994–994Q, as inserted by the DDO Act.

86. Corporations Act, proposed section 1023A.

87. Which, as discussed above, are not covered by design and distribution requirements introduced by the DDO Act. Credit products regulated by the National Credit Act comprise, in summary, credit provided to individuals (and strata corporations)—referred to as "consumers"—for personal, domestic, or household purposes or for investment in residential property.

88. In the case of financial products other than consumer credit, these will be retail clients as discussed above (that is, including some small businesses). In the case of consumer credit, these will be consumers (that is, primarily individuals).

89. Corporations Act, section 1023D, and National Credit Act, section 301D, as inserted by the DDO Act.

90. Corporations Act, section 1023E, and National Credit Act, section 301E, as inserted by the DDO Act.

91. Corporations Act, section 1023F, and National Credit Act, section 301F, as inserted by the DDO Act.

Product intervention orders remain in force for an initial specified period of up to 18 months.⁹² ASIC may extend an order by declaring that it remains in force until it is revoked or remains in force for a specified period, unless revoked earlier. However, this requires approval of the Minister. ASIC, with the Minister's approval, may also amend an order (although it may not extend the time of the order beyond the maximum period for the order). ASIC may revoke an order, in writing, with the Minister's approval. However, ASIC cannot remake a product intervention order unless it is satisfied that the circumstances have materially changed since the order was made or the Minister approves it.⁹³

ASIC must serve a copy of the order or amendment on any person to whom it considers the order applies. However, failure to do so does not invalidate the order or amendment. ASIC must also publish each order or amendment on its website, along with a notice describing the significant detriment or the reasons why the amendment is appropriate, the consultation it undertook, and the day the order or amendment comes into force, if this day comes after the order is published. ASIC must also publish notice of revocation of an order on its website.⁹⁴

Penalties apply if there is conduct contrary to a product intervention order.⁹⁵ The maximum penalty is \$A200,000 and/or five years' imprisonment for an individual and \$A1 million for a corporation. However, such penalties do not apply if the person was not aware and could not reasonably have been aware of the order (except if it was a legislative instrument).

Clients also have recourse rights following a breach. In particular, they may recover loss or damages for relevant contraventions.⁹⁶ This is regardless of whether there has been a conviction, a court has made a declaration of contravention, or a court has ordered anyone to pay a pecuniary penalty in relation to the contravention. Courts may also make orders voiding contracts, orders for the return of money paid, and orders for the payment of interest.

In recently released draft guidance, ASIC has highlighted how it may use such powers, including in a retail banking

context.⁹⁷ For example, ASIC highlighted a historical case study in which it may have intervened had such powers been available to it at that time. Australian deposit-taking institutions in the past had engaged in a deliberate strategy to promote their term deposits by advertising higher interest rates available only on some deposit terms, while maintaining significantly lower interest rates for all other deposit terms. ASIC notes that such products were marketed as suitable for consumers, including retirees who wanted a safe investment with a steady return that required minimal management, and this is how they were perceived by the market. However, the dual pricing practice, and the fact that after their initial maturity date, term deposits could automatically roll over to much lower rates, meant that these products functioned in a way potentially inconsistent with expectations of relevant consumers.

EUROPEAN UNION

The EU's regime for retail banking product design, distribution, and governance is set out in the EBA Guidelines. The EBA Guidelines came into effect on January 3, 2017, and apply to various consumer credit products, deposits, and payment services. They do not apply to structured deposits, which, along with other investment products and services, are governed by the design and distribution obligations contained in Article 24 of the Markets in Financial Instruments Directive 2014/65/EU (MiFID II). The implementation of Article 24 is given detailed consideration in the case study further below on the UK.

The EBA Guidelines are directed at the competent authorities of Member States, who must comply with them by incorporating them into their legal framework or supervisory processes, as appropriate.⁹⁸ The Central Bank of Ireland, for example, has stated on its website that it will incorporate the EBA Guidelines into its ongoing supervisory practices and processes but does not currently propose changes to the country's legal framework.⁹⁹ According to the EBA,¹⁰⁰ some or all competent authorities in nine countries, including Belgium, Croatia, Norway, and Sweden, had complied with the EBA Guidelines by February

92. Corporations Act, section 1023G(2), and National Credit Act, section 301G(2), as inserted by the DDO Act.

93. Corporations Act, sections 1023H–1023K and 1023M, and National Credit Act, sections 301H–301K and 301M, as inserted by the DDO Act.

94. Corporations Act, section 1023L, and National Credit Act, section 301L, as inserted by the DDO Act.

95. Corporations Act, section 1023P, and National Credit Act, section 301P, as inserted by the DDO Act.

96. Corporations Act, section 1023Q. The National Credit Act already contains provisions that allow for equivalent recourse. See DDO Explanatory Memorandum, 2.80.

97. Australian Securities and Investments Commission 2019, pages 11–14. See also recent ASIC proposals with regard to short term credit (<https://asic.gov.au/regulatory-resources/find-a-document/consultation-papers/cp-316-using-the-product-intervention-power-short-term-credit/>) and the sale of certain complex and risky products to retail clients (<https://asic.gov.au/about-asic/news-centre/find-a-media-release/2019-releases/19-220mr-asic-proposes-ban-on-the-sale-of-binary-options-to-retail-clients-and-restrictions-on-the-sale-of-cfds/>)

98. EBA Guidelines, page 3, paragraph 2.

99. Central Bank of Ireland n.d.

100. EBA 2018.

2018. Authorities in a further 21 countries, including the UK, had indicated that they intended to comply.¹⁰¹ Certain authorities had notified the EBA that they will not comply—for example, authorities in Austria and Slovakia indicated they will not be compliant because they lack the regulation necessary at the national level to implement the EBA Guidelines.

The case study below also considers the EBA's (and national regulators') product intervention powers for

structured deposits under MiFIR. At present, the EBA's product intervention powers do not extend to retail banking products other than structured deposits. This is because they are part of a separate regime for investment products and services (including structured deposits) established by MiFID II and its supporting regulations in MiFIR. MiFIR provides for product intervention powers over relevant products being given to national authorities but also provides that the EBA may exercise its own product intervention powers in excep-

KEY TERMS

SOURCE/LEGISLATION	KEY TERM	DEFINITION
EBA Guidelines, para. 15	Manufacturer	An undertaking that designs (that is, creates, develops, combines, or significantly changes) products to be offered to consumers and that is <ul style="list-style-type: none"> • a credit institution;¹⁰² • a creditor;¹⁰³ • a payment institution;¹⁰⁴ or • an electronic money institution;¹⁰⁵ or that would otherwise be a distributor but is involved de facto in the design of the product.
EBA Guidelines, para. 15	Distributor	A person who offers and/or sells the product to consumers. This includes business units of manufacturers that are not involved in designing the product but are responsible for bringing the product to the market.
EBA Guidelines, para. 15	Consumer	A natural person who is acting for purposes that are outside their trade, business, or profession.
EBA Guidelines, para. 15	Target market	The group or groups of end consumers for whom the product is designed, as defined by the manufacturer.
EBA Guidelines, para. 15	Products	<ul style="list-style-type: none"> • Credit agreements relating to immovable property;¹⁰⁶ • “deposits”;¹⁰⁷ • “payment accounts”;¹⁰⁸ • “payment services”;¹⁰⁹ • “payment instruments”;¹¹⁰ • other means of payment;¹¹¹ • “electronic money”;¹¹² or • other forms of credit for consumers (that is, in addition to credit agreements relating to immovable property) provided by the manufacturers listed above, in line with Article 1(5)(e) of Regulation (EU) No 1093/2010.

101. Note that since January 3, 2017 (the date the EBA Guidelines came into effect), competent national authorities that have not implemented the EBA Guidelines are considered noncompliant, even if they continue to intend to comply.

102. Defined in Article 4(1) of the Capital Requirements Regulation (EU) 575/2013 as an undertaking the business of which is to take deposits or other repayable funds from the public and to grant credits for its own account.

103. Defined in Article 4(2) of Directive 2014/17/EU (Mortgage Credit Directive) as a natural or legal person who grants or promises to grant credit falling within the Directive in the course of his or her trade, business, or profession.

104. The EBA Guidelines refer to several definitions in Directive 2007/64/EC (Payment Services Directive), which has now been replaced by Directive 2015/2366/EU (PSD2). The cross-reference to the previous Directive is preserved here for consistency with the wording of the Guidelines, noting where the same or similar definitions are now included in PSD2. Article 4(4) of the Payment Services Directive defined a payment institution as a legal person that had been granted authorization in accordance with the Directive to provide and execute payment services throughout the European Union. This definition is replicated in PSD2.

105. Defined in Article 2(1) of Directive 2009/110/EC (Electronic Money Directive) as a legal person that has been granted authorization to issue electronic money.

106. Defined in the Mortgage Credit Directive as an agreement whereby a creditor grants or promises to grant, to a consumer, a credit falling within the scope of the Directive in the form of a deferred payment, loan, or other similar financial accommodation.

107. Defined in Article 2(3) of Directive 2014/49/EU (Deposit Guarantee Scheme Directive) as a credit balance that results from funds left in an account or from temporary situations deriving from normal banking transactions and that a credit institution is required to repay under the legal and contractual conditions applicable, including a fixed-term deposit and a savings deposit.

108. Defined in Article 4(14) of the Payment Services Directive as an account held in the name of one or more payment service users that is used for the execution of payment transactions. The definition has been replicated in PSD2.

109. Defined in article 4(3) of the Payment Services Directive as any business activity set out in its Annex, which included, for example, cash deposit and withdrawal services, execution of payment transactions, and money remittance. PSD2 contains a similar list.

110. Defined in Article 4(23) of the Payment Services Directive as any personalized device(s) and/or set of procedures agreed between the payment service user and the payment service provider and used by the user to initiate a payment order. A similar definition is included in PSD2.

111. As listed in Annex 1(5) of Directive 2013/36/EU (Capital Requirements Directive IV)—for example, travellers' cheques and bankers' drafts.

112. As defined in Article 2(2) of the Electronic Money Directive (in summary, electronically, including magnetically, stored monetary value accepted by persons other than the issuer of the electronic money).

tional cases where competent national authorities have not intervened.

Who Must Comply

The POG arrangements set out in the EBA Guidelines are applicable to creditors; credit intermediaries; and credit, investment, payment, and electronic money institutions that fall within the definition of a “manufacturer” or a “distributor” set out under “Key Terms” above.¹¹³ These persons and institutions are covered by the EBA Guidelines in relation to products offered and sold to “consumers” as defined.

The EU Guidelines also note that competent authorities may wish to extend the scope of application of the Guidelines. In particular, it is suggested that competent authorities could consider extending the Guidelines as follows:

- The Guidelines could apply to intermediaries other than credit intermediaries covered by the EU Mortgage Credit Directive, such as consumer credit intermediaries. (It is understood that this is a reference to unsecured credit intermediaries who are outside the scope of the EU Mortgage Credit Directive, although they may be covered by the EU Consumer Credit Directive.)
- The protections in the Guidelines could apply for the benefit of persons outside the current definition of a “consumer,” such as microenterprises and small and medium-sized enterprises.¹¹⁴

Affected Products

The product categories to which the Guidelines apply are listed under “Key Terms.” They cover a wide range of products including, relevantly in this context, consumer credit and account and payment/transaction products.

Key Requirements for Issuers/Manufacturers and Distributors

Governance arrangements

The EBA Guidelines require both manufacturers and distributors to establish, implement, and review effective

POG arrangements. These should aim to ensure that, when products are being designed and marketed, the interests, objectives, and characteristics of consumers are taken into account, that potential consumer detriment is avoided, and that conflicts of interest are minimized.¹¹⁵

There is provision for proportionality in relation to POG arrangements. A manufacturer’s POG arrangements should be proportionate to the nature, scale, and complexity of the manufacturer’s business, and potential consumer risk and product complexity need to be considered in the implementation and application of the arrangements.¹¹⁶ The requirement for distributors is that they have arrangements that are proportionate to their size and role.¹¹⁷

Both manufacturers and distributors should ensure that POG arrangements are an integral part of their governance, risk-management, and internal control framework.¹¹⁸ Their management bodies need to endorse the establishment of POG arrangements and subsequent reviews. Senior management of manufacturers should be responsible for continued internal compliance, periodically checking that their POG arrangements are still appropriate.¹¹⁹ Manufacturers’ senior management should also ensure that staff members involved in designing a product are familiar with the POG arrangements, understand the product’s features, characteristics, and risks, and are competent and appropriately trained.¹²⁰

When launching a new product, the manufacturer should ensure that the POG arrangements are considered in its new product approval policy. Having such a policy is a requirement of the EBA’s Guidelines on Internal Governance.¹²¹

Manufacturers and distributors also have recordkeeping obligations. All actions taken by the manufacturer and the distributor in relation to their POG arrangements should be documented, kept for audit purposes, and made available to competent authorities on request.¹²²

Target market assessments

Target market assessments are primarily the manufacturer’s responsibility under the EBA Guidelines. Manufactur-

113. EBA Guidelines, page 4, paragraph 6.

114. EBA Guidelines, para. 7–8.

115. EBA Guidelines, guidelines 1.1 and 9.1.

116. EBA Guidelines, guideline 1.5.

117. EBA Guidelines, guideline 9.1.

118. EBA Guidelines, guidelines 2.1 and 10.1.

119. EBA Guidelines, guideline 2.2.

120. EBA Guidelines, guideline 2.4.

121. EBA Guidelines, guideline 1.3.

122. EBA Guidelines, guidelines 1.4 and 9.3.

ers must include, in their POG arrangements, steps and features that need to be followed to identify (and update as necessary) the relevant target market of a product. Having identified the target market, the manufacturer should ensure that the product is deemed appropriate for the interests, objectives, and characteristics of the target market, considering the features, charges, and risks of the product.¹²³ The manufacturer should also consider how the product fits within their product range and whether the existence of too many product variants prevents informed decisions.¹²⁴ The manufacturer should also identify the market segments for which the product would be inappropriate.¹²⁵

In identifying whether a product meets the interests, objectives, and characteristics of a target market, manufacturers should assess the degree of financial capability of the target market.¹²⁶ The EBA, in its final report leading up to the introduction of the EBA Guidelines, referred to “good practice examples” for compliance with target market assessment requirements, providing the following examples:

Target market

Manufacturers could consider the following:

- (i) tax status implications for different products,
- (ii) level of risks of the product to be designed,
- (iii) liquidity accessibility that the consumer is expected to get,
- (iv) level of risks that the consumer is willing to bear,
- (v) demographic factors,
- (vi) level of knowledge and understanding of the complexity of the product, or
- (vii) potential creditworthiness of the consumer or financial capability of the consumer.¹²⁷

Product design and testing requirements

Product design must take the target market into account. As noted above, manufacturers must ensure that a product is deemed appropriate for the interests, objectives, and characteristics of the target market and consider how it fits in their product range. The EBA Guidelines explicitly say that a manufacturer should design and bring to market only products with features, charges, and risks that

meet such interests, objectives, and characteristics and benefit the target market.¹²⁸

Manufacturers also have product testing obligations that must be fulfilled before a product is brought to market. These obligations apply to new products, existing products brought to new target markets, and also to significant changes made to existing products. The manufacturer should conduct product testing to assess how the product would affect its consumers under a wide range of scenarios, including stressed scenarios, and make changes to the product to address poor test results.¹²⁹

Distribution requirements

The manufacturer should select distribution channels that are appropriate for the particular target market.¹³⁰ To that end, manufacturers should select distributors who have the appropriate knowledge, expertise, and capability to place each product in the market correctly and to provide to consumers appropriate explanations of the characteristics and risks of the product. When selecting its distribution channels, a manufacturer may consider limiting the distribution of a specific product to channels that offer specific features to consumers.

Manufacturers should take all reasonable steps to ensure that distributors act in compliance with the objectives of the manufacturer’s POG arrangements.¹³¹ Manufacturers should monitor distribution, and both manufacturers and distributors should ensure that sales outside the target market are made only on a justified basis.¹³² The distributor should be able to provide information to justify to the manufacturer why it offered a product to a consumer outside the target market.¹³³

Manufacturers should provide distributors with information about a product that is clear, precise, up to date, and of an adequate standard. Distributors should be given a description of the main characteristics of the product, its risks and any limitations, and the total price of the product to be borne by the consumer, including all related fees, charges, and expenses. The information should be sufficient to enable the distributor to understand the product and properly place it in the market, and to recognize the

123. EBA Guidelines, guidelines 3.1–3.2.

124. EBA Guidelines, guideline 3.4.

125. EBA Guidelines, guideline 3.5.

126. EBA Guidelines, guideline 3.6.

127. EBA 2015, page 73.

128. EBA Guidelines, guideline 3.3.

129. EBA Guidelines, guideline 4.1.

130. EBA Guidelines, guideline 7.1.

131. EBA Guidelines, guideline 7.3.

132. EBA Guidelines, guidelines 7.2 and 12.2.

133. EBA Guidelines, guideline 12.2.

target market for whom the product is designed. Distributors should then disclose this information to the consumer, along with any additional information supplied by the manufacturer.¹³⁴ Further, distributors should use this information along with their own relevant knowledge to determine whether a consumer belongs to the target market.¹³⁵

Product review requirements

Once a product is brought to market, the manufacturer is ultimately responsible for product monitoring. The manufacturer should monitor the product on an ongoing basis to ensure that the interests, objectives, and characteristics of consumers continue to be taken into account appropriately.¹³⁶ To assist the manufacturer with this obligation, distributors should, on an ongoing basis, collect relevant information about the product. If the distributor identifies any problems related to the product's features, its information, or the target market when offering and selling the product, the distributor should promptly inform the manufacturer.¹³⁷

If a manufacturer identifies a problem related to a product in the market, they should take necessary action to mitigate the situation and prevent further detriment. The remedial actions should include promptly notifying the distributor of any changes or modifications to the product, and any additional actions that need to be taken to remedy the situation.¹³⁸

Outsourcing

Manufacturers and/or distributors, when their activities are wholly or partly outsourced, should ensure that they comply with the requirements established in the Committee of European Banking Supervisors Guidelines on Outsourcing. Among other things, these guidelines provide that "the ultimate responsibility for the proper management of the risks associated with outsourcing or the outsourced activities lies with an outsourcing institution's senior management."¹³⁹

Applicable Penalties

The EBA Guidelines themselves do not include any penalties for manufacturers or distributors in the event of breach. The EBA Guidelines are directed at competent authorities of Member States, who in turn must adopt them and apply domestic enforcement regimes.

Product Intervention Powers

Article 42 of MiFIR contemplates that competent authorities may exercise product intervention powers in relation to (among other products covered by MiFIR) structured deposits. Such powers comprise prohibiting or restricting

- the marketing, distribution, or sale of certain structured deposits or structured deposits with certain specified features; or
- a type of financial activity or practice.

A competent authority may exercise these powers only if all of the following conditions are fulfilled (in summary):

- The relevant structured deposit or activity or practice gives rise to significant investor protection concerns or poses a threat to the orderly functioning and integrity of financial markets or to the stability of whole or part of the financial system within at least one Member State.
- Existing regulatory requirements under applicable EU law do not sufficiently address relevant risks, and the issue would not be better addressed by improved supervision or enforcement of existing requirements.
- The action is proportionate, taking into account the nature of the risks identified, the level of sophistication of clients concerned, and the likely effect of the action on such clients.
- The competent authority has properly consulted competent authorities in other Member States that may be significantly affected by the action, and the action would not discriminate against services or activities from another Member State.

A competent authority may impose a prohibition or restriction on a precautionary basis before a structured deposit has been marketed, distributed, or sold to clients.

A competent authority must consider the following criteria, among others, in determining whether there is a significant investor protection concern or a threat to the orderly functioning and integrity of financial markets or to the stability of the financial system within at least one Member State:

134. EBA Guidelines, guidelines 8 and 12.1.

135. EBA Guidelines, guideline 11.

136. EBA Guidelines, guideline 5.

137. EBA Guidelines, guidelines 12.3–12.4.

138. EBA Guidelines, guideline 6.

139. EBA Guidelines, page 15.

- The degree of complexity of the structured deposit and its relation to the type of client to whom it is marketed and sold
- The degree of innovation involved
- The size or notional value of the structured deposits
- The leverage a structured deposit provides

A competent authority must notify the European Securities and Markets Authority and other competent authorities at least one month prior to exercising such powers. However, in certain prescribed circumstances, the authority may take provisional action in the meantime (for up to three months) with at least 24 hours' notice.

A competent authority must publish on its website notice of any decision to exercise these powers. The notice must specify details of the prohibition or restriction and a time after the publication of the notice at which the measures will take effect and the evidence on which they are based. A prohibition or restriction shall apply only to action taken after the measures take effect.

Article 41 of MiFIR also gives the EBA temporary product intervention powers in relation to structured deposits. These powers allow the EBA to temporarily prohibit or restrict in the EU

- the marketing, distribution, or sale of certain structured deposits or structured deposits with certain specified features; or
- a type of financial activity or practice.

The EBA can exercise these powers only if all of the following conditions are fulfilled:

- The proposed action addresses a significant investor protection concern or a threat to the orderly functioning and integrity of the financial markets or to the stability of the whole or part of the EU's financial system.
- Regulatory requirements under EU law that are applicable to the relevant structured deposit or activity do not address the threat.
- A competent authority or competent authorities have not taken action or have not taken adequate action to address the threat.

The EBA must consider the following criteria, among others, in determining whether there is a significant investor

protection concern or a threat to the orderly functioning and integrity of the financial markets or to the stability of the whole or part of the EU's financial system:

- The degree of complexity of the product and its relation to the type of client to whom it is marketed and sold
- The size or notional value of the product
- The degree of innovation involved.

Where the first condition is fulfilled, the EBA may impose the prohibition or restriction on marketing, distribution, or sale of a structured deposit on a precautionary basis, before it can be brought to the market.

When using these powers, the EBA must ensure that the action does not have a detrimental effect on the markets or on investors that is disproportionate to the benefits of the action. The EBA must also ensure the action does not create a risk of regulatory arbitrage.

Before deciding to exercise its product intervention powers, the EBA must notify competent authorities of Member States of the action it proposes. It must also publish on its website notice of any decision to exercise the powers. The notice must specify details of the prohibition or restriction and specify a time after the publication of the notice at which the measures will take effect. A prohibition or restriction shall apply only to action taken after the measures take effect. Any prohibition or restriction imposed must be reviewed by the EBA at appropriate intervals and at least every three months. If the prohibition or restriction is not renewed after that three-month period, it shall expire.

The exercise of these powers by the EBA will prevail over any previous action taken by the competent authorities of Member States.

HONG KONG

Design and Distribution Obligations

Hong Kong does not currently have detailed design and distribution obligations relating to retail banking products.¹⁴⁰ However, in October 2013, the HKMA issued its TCF Charter for retail banks, addressing, among other things, product design obligations for banks. According to the HKMA, all retail banks have signed up to the Charter.¹⁴¹

140. Note, however, that the HKMA issued a circular on October 28, 2013, setting out high-level principles applicable to retail banks, including the principle that banking services and products should be designed to meet the needs of customers.

141. See HKMA, "HKMA's Work in Relation to Strengthening Financial Consumer Protection" and "List of the 22 Retail Banks Which Have Signed Up to the TCF Charter."

Principle 1 of the TCF Charter addresses product design. It relevantly states: “Banking services and products should be designed to meet the needs of customers.” By circular issued on March 28, 2014, the HKMA provided examples of measures that banks should take to implement Principle 1, noting that “[b]anks should design services and products that meet the needs of their target customer segments, rather than designing services and products just to maximize profit.”

Product Intervention Powers

The HKMA has powers (as held by many licensing authorities) to restrict the business that may be undertaken by entities that it authorizes to carry on banking business or undertake deposits. It can modify the conditions of its authorizations to impose restrictions, either generally or in any particular case, on the business that may be carried on by an authorized institution.¹⁴² (However, it does not seem to have intervention powers under a regime similar to that discussed in other cases studies here.)

SOUTH AFRICA

While in South Africa there are currently very limited product intervention provisions,¹⁴³ the recently proposed COFI Bill would introduce a broad new PDD regime. A consultation draft of the COFI Bill was published for public comment, along with an accompanying Explanatory Policy Paper on December 11, 2018.¹⁴⁴ The COFI Bill sets out a proposed market conduct framework to apply under South Africa’s new twin-peaks regulatory model. It includes proposed PDD obligations for financial institutions. The stated objective of chapter 4 of the Bill, which includes the new PDD rules, is “to promote the supply to financial customers of products that are appropriate to targeted customer needs, circumstances and expectations, while facilitating efficiency, flexibility and innovation.”¹⁴⁵ The COFI Bill also provides for the FSCA to have product intervention powers.¹⁴⁶ These provisions are discussed below as if they were to be passed in their current form. They may of course change as the result of the ongoing consultation and legislative development process.

The COFI Bill specifies the following overarching principles for the design and provision of financial products (Principles):¹⁴⁷

- Financial products must be designed with due regard to the interest of financial customers and, in the case of retail financial customers, must be designed to meet the needs of identified groups of financial customers and must be targeted accordingly.
- A financial product provider must ensure that their financial customers are provided with products that perform as that provider has led its customers to expect, through the information, representations, and advertising provided by or on behalf of the financial product provider.
- A financial product provider must ensure that relevant personnel involved in designing a financial product possess the necessary skills, knowledge, and expertise to understand properly the financial product’s main features and characteristics, as well as the interests, objectives, and characteristics of the target market.

Who Must Comply

The new PDD requirements introduced by the COFI Bill apply primarily to a “financial product provider.” This term appears to be intended to cover issuers or manufacturers of financial products. However, the provisions also refer to institutions involved in distributing (or advising on) financial products.

Affected Products

All products covered by section 2 of the FSRA are subject to the new obligations. These include but are not limited to, deposits, credit products and warranties, guarantees, or other credit support arrangements. While the provisions apply to products provided to financial customers generally, as discussed below, key obligations focus on retain financial customers.

142. Banking Ordinance (Cap 155), section 16(9).

143. For example, section 89(e) of the National Credit Act, 2006 contemplates that the National Credit Regulator may issue notices to stop credit providers from offering particular forms of credit agreements.

144. National Treasury, Republic of South Africa 2018.

145. COFI Bill, section 46. Chapters 6 and 7 of the COFI Bill also set out (among other matters) requirements concerning product promotion, marketing, distribution, and disclosure.

146. COFI Bill, section 51.

147. COFI Bill, section 47.

KEY TERMS

SOURCE/LEGISLATION	KEY TERM	DEFINITION
COFI Bill, section 1(1)	Financial product	The COFI Bill refers to the definition of a “financial product” in section 2 of the Financial Sector Regulation Act, 2017 (FSRA). The products covered include in summary and among others <ul style="list-style-type: none"> • deposits; • the provision of credit; and • a warranty, guarantee, or other credit-support arrangement.
COFI Bill, section 1(1)	Financial institution	The COFI Bill refers to the definition of a “financial institution” in section 1(1) of the FSRA, which includes <ul style="list-style-type: none"> • a financial product provider; • a financial service provider; • a holding company of a financial conglomerate; or • a person licensed or required to be licensed in terms of a financial sector law.
FSRA, section 1(1)	Financial product provider	There is no separate definition in the COFI Bill, but section 1(1) of the FSRA relevantly defines this term as a “person that, as a business or as part of a business, provides a financial product.” ¹⁴⁸
FSRA section 1(1)	Financial customer	Section 1(1) of the FSRA relevantly defines this term as a “person to, or for, whom a financial product, a financial instrument, a financial service or a service provided by a market infrastructure is offered or provided, in whatever capacity, and includes a successor in title of the person and the beneficiary of the product, instrument or service.”
COFI Bill, section 1(1)	Retail financial customer	A “retail financial customer” is, in summary, a financial customer that is a natural person or a juristic person whose asset value or annual turnover is less than the threshold value to be determined by the Minister.

Key Requirements for Issuers/Manufacturers and Distributors

Governance arrangements

Financial product providers must establish and implement product oversight arrangements relating to the design of financial products. These arrangements must provide for the monitoring and review the design process and procedures on an ongoing basis and ensure that remedial action is taken with regard to financial products that are reasonably expected to lead, or are leading, to poor or unfair outcomes for financial customers. Each new financial product must be signed off on by the provider’s governing body before it is marketed, and this sign-off must be accompanied by a confirmation that the product, its distribution methods, and its disclosure documents all meet the requirements for financial product oversight arrangements discussed below.¹⁴⁹

The financial product oversight arrangements must also

- support the achievement of the principles and objective specified in chapter 4 of the COFI Bill (as noted above) and must include senior management confirmation in this regard;
- support the proper management of conflicts of interest and ensure that the objectives, interests, and char-

acteristics of targeted financial customers are duly taken into account;

- be appropriate to account for risks borne by financial customers or groups of financial customers for a financial product;
- allocate clear roles and responsibilities for the people responsible for establishing and implementing the oversight arrangements;
- incorporate effective assessment by the risk and compliance functions of the extent to which relevant principles and objectives are being achieved;
- include senior management confirmation that a product adequately meets the required outcomes for the fair treatment of financial customers, including the requirement that it will perform as financial customers are led to expect;
- include appropriate measures and procedures to ensure the financial institution’s compliance with the COFI Bill’s product design provisions; and
- be reviewed regularly by the financial product provider to ensure that the arrangements remain valid and up to date and must be amended where appropriate.¹⁵⁰

148. Section 1(1) of the COFI Bill states that terms not defined in the bill but defined in the FSRA have the same meaning.

149. COFI Bill, section 48.

150. COFI Bill, section 48(2).

The COFI Bill expressly provides for proportionality of application of these requirements. The product oversight arrangements may vary depending on the product and considerations of proportionality, taking into account the nature, scale, and complexity of the relevant business and the product.¹⁵¹

In addition, providers who are not “small enterprises”¹⁵² must

- include a product approval process and a product design policy in their oversight arrangements (and ensure that the policy is not compromised as a result of commercial, time, or funding pressures);
- review and update the product approval process on a regular basis to ensure that it remains robust and fit for purpose; and
- set out their financial product oversight arrangements in their governance policy prescribed by the Bill¹⁵³ and make them available to all relevant persons involved in product design.¹⁵⁴

Target market assessments and product design and testing requirements

A financial institution providing products to “retail customers” must do the following:

- When developing the product, make use of adequate information on retail financial customers’ needs and undertake a thorough assessment of the main characteristics of a new product, proposed distribution methods, and related disclosure documents. This assessment must be done by competent persons with relevant skills to ensure that each of these items
 - are consistent with the financial institution’s business model, risk-management approach, and applicable conduct standards;
 - target the retail customers for whose needs the product is likely to be appropriate, while taking reasonable measures to limit access by retail customers for whom it is likely to be inappropriate;
 - take into account any risks of harm to retail customers resulting or potentially resulting from the product; and

- are appropriate, taking into account considerations of fairness.

- Take appropriate steps to identify the needs of the target market prior to making the product available to the market, and ensure, on an ongoing basis, that the product is appropriate to meet those needs.
- Ensure that the design provides sufficient flexibility to cope with reasonably expected changes in a customer’s needs during the lifetime of the product.
- Adjust the design to respond to identified changes affecting the product and customers.¹⁵⁵

Distribution requirements

Chapter 7 of the COFI Bill contains provisions relating to distribution of a financial product. The stated purposes of the chapter are to ensure (in summary) that distribution

- supports the delivery of appropriate financial products and instruments to customers;
- enables customers to understand and compare the nature, value, and costs of these products and instruments;
- enhances standards of professionalism;
- enables customers and distributors to benefit from fair competition; and
- supports viable, sustainable business models to deliver fair customer outcomes over the long term.¹⁵⁶

Financial institutions must satisfy themselves that the methods used to distribute their product are appropriate to the nature and complexity of that product and to the target market. They must, if selecting distributors, select those possessing the necessary knowledge, expertise, and competence to understand the target market, correctly place the product in the market, and give appropriate information to customers.¹⁵⁷ Distribution services must also be provided in an objective manner and must not be conflicted where conflict can be avoided (and conflict must be disclosed in all instances).¹⁵⁸

Product providers must give adequate information about their product to distributors. The information must be of an

151. COFI Bill, section 48(3).

152. Defined in section 1 of the National Small Enterprise Act, 1996, as a separate and distinct business entity managed by one owner or more predominantly carried on in a particular sector of the economy (specified by the Act) and classified as a micro-, very small, small, or medium enterprise by satisfying the criteria specified in the Act.

153. See COFI Bill, section 36.

154. COFI Bill, sections 48(4)–48(6).

155. COFI Bill, section 49.

156. COFI Bill, section 63.

157. COFI Bill, sections 65(1)–65(2).

158. COFI Bill, section 64.

adequate standard, clear, precise, and up to date and allow distributors to identify and understand the target market and correctly place the product in it and identify the customers for whom the product will be inappropriate.¹⁵⁹

A distributor must take all reasonable steps to ensure that their distribution or advice channels act in compliance with the objectives of their governance policy and distribution or advice model. Where distributors are of the opinion that their distribution or advice channels don't meet these objectives, they must take remedial action.¹⁶⁰

The COFI Bill sets out several requirements for distribution models. These include requirements that distribution models must

- provide that ultimate responsibility for the customer rests with the product provider and that distributors are responsible to both the customer and the product provider with regard to the quality of distribution activities;
- ensure that adequate information is provided to the product provider to enable them to be sufficiently informed about the product so that they can comply with their own obligations and adequately monitor and assess the performance of the distribution model; and
- ensure that adequate information is obtained from customers to ensure that the sale and distribution of the product or instrument are appropriate.¹⁶¹

Both product providers and distributors must ensure that the distribution model used is compliant with the requirements of the COFI Bill.¹⁶²

The FSCA can prescribe conduct standards that provide additional requirements, limitations, or prohibitions on distribution.¹⁶³

Product review requirements

Products must be subject to ongoing monitoring and periodic reporting of product performance, to allow financial customers to make ongoing, informed decisions. Distributors must monitor, on a regular basis, whether the products or instruments they distribute are being provided to customers within the target market.¹⁶⁴

Applicable Penalties

There are no specific penalties for contravention of the provisions discussed above. However, penalties may be specified as the draft Bill progresses. It should also be noted that the COFI Bill sets up a licensing regime for financial institutions, which must be licensed by the FSCA. Compliance with the COFI Bill's provisions is one of the conditions for obtaining and keeping a license.¹⁶⁵

New Conduct Standard for Banks

Notably, at the time of writing the FSCA is proposing to introduce a Conduct Standard for banks pursuant to its existing powers under the FSRA¹⁶⁶ that would impose, among other obligations, some PDD obligations ahead of the enactment of the PDD rules discussed above.¹⁶⁷ The Conduct Standard would impose on banks obligations with regard to financial product design very similar to those proposed in the COFI Bill (particularly with regard to governance arrangements and target market assessments) as discussed above.

Product Intervention Powers

The FSCA is given product intervention powers under section 51 of the COFI Bill. Section 51(2) gives the FSCA the power, among others, to prescribe conduct standards regarding prohibition of or imposition of restrictions on the offer of products to certain types of customer. The FSCA may also prescribe conduct standards that address prohibited financial products. The Policy Paper accompanying the COFI Bill states the following:

It is anticipated that the FSCA will be able to [...] prohibit the inclusion of potentially harmful product features, either in their entirety or when products are designed for specific target markets. The FSCA will have intervention powers where it becomes apparent that products or services issued are not delivering appropriate outcomes.¹⁶⁸

When prescribing conduct standards, the FSCA must consider the following, among other things:

- The nature, scale, and complexity of different financial institutions, products and services

159. COFI Bill, sections 65(3)–(4).

160. COFI Bill, sections 65(5)–(7).

161. COFI Bill, section 66(1).

162. COFI Bill, sections 66(2)–(3).

163. COFI Bill, section 69.

164. COFI Bill, section 65(6).

165. COFI Bill, Chapter 2.

166. Draft Conduct Standard 1 of 2019 (Banks).

167. See Statement Supporting the Draft Conduct Standard (2019).

168. National Treasury, Republic of South Africa. 2018, page 47.

- The need to
 - provide fair access to appropriate products and services;
 - enable financial customers to understand and compare the nature, value, and cost of financial products and financial services;
 - enable financial customers to benefit from fair competition for quality financial products and financial services;
 - support sustainable business models that enable financial institutions to be able to deliver fair customer outcomes; and
 - facilitate access to market for emerging financial institutions.¹⁶⁹

tion to them in a way which is clear, fair and not misleading.¹⁷⁰

The rules are applicable to financial instruments, including structured deposits, but do not apply to other retail banking products, such as credit products and ordinary deposits and payment products.

The purpose of the rules is to improve firms’ POG processes and to set out the FCA’s statement of policy on making temporary product intervention rules. The Sourcebook notes that the result of good governance should be products that meet the needs of one or more identifiable target markets, are sold to clients in the target markets by appropriate distribution channels, and deliver appropriate client outcomes.¹⁷¹

UNITED KINGDOM

The UK’s PDD regime discussed here comprises the rules (and related guidance) set out in the Sourcebook. These rules have been drafted with reference to the FCA’s Principles for Businesses, particularly the following:

- **Principle 2:** A firm must conduct its business with due skill, care, and diligence.
- **Principle 3:** A firm must take reasonable care to organize and control its affairs responsibly and effectively, with adequate risk-management systems.
- **Principle 6:** A firm must pay due regard to the interests of its customers and treat them fairly.
- **Principle 7:** A firm must pay due regard to the information needs of its clients and communicate informa-

The rules contained in the Sourcebook build on, and make obligatory, the guidance provided by the FCA in its non-binding Guidance Note on the Responsibilities of Providers and Distributors for the Fair Treatment of Customers, which is applicable to all regulated firms. The rules also give effect to the FCA’s guidance as to consumer outcomes that firms should strive to achieve in order to ensure fair treatment of customers, particularly Outcome 2, which requires that “products and services marketed and sold in the retail market are designed to meet the needs of identified consumer groups and are targeted accordingly.”¹⁷²

The FCA is given product intervention powers by the FSMA. As contemplated by the legislation, the FCA has issued a statement specifying how it will exercise such powers.

KEY TERMS

SOURCE/LEGISLATION	KEY TERM	DEFINITION
FCA Handbook of Rules and Guidance—Glossary ¹⁷³ (FCA Glossary)	Manufacturer	A firm that creates, develops, issues, and/or designs investments (which relevantly include structured deposits), including when advising corporate issuers on the launch of new investments.
FCA Glossary	Distributor	A firm that offers, recommends, or sells investments or provides investment services to clients.
FCA Glossary, Sourcebook, 3.1.1R	Financial instruments	For relevant purposes, a financial instrument includes structured deposits.
FCA Glossary	Client	The definition includes (subject to exceptions) a person to whom a firm, in the course of carrying on a regulated activity, provides, intends to provide, or has provided a service (or, in the case of MiFID firms, any of certain specified services).

169. COFI Bill, section 107(2).

170. “The Responsibilities of Providers and Distributors for the Fair Treatment of Customers,” *FCA Handbook of Rules and Guidance*, 1.5, https://www.handbook.fca.org.uk/handbook/document/RPPD_FCA_20130401.pdf.

171. Sourcebook, 1.1.3G.

172. FCA 2015.

173. FCA Handbook of Rules and Guidance – Glossary.

Who Must Comply and Affected Products

The Sourcebook imposes product governance obligations on firms that manufacture and distribute, relevantly for this discussion, financial instruments, which include structured deposits. These rules implement the provisions of the EU's MiFID II.

The obligations governing the manufacture and distribution of financial instruments apply to credit institutions and investment firms within the ambit of relevant EU directives and branches of third-country investment firms that manufacture and distribute financial instruments.¹⁷⁴ Other firms that manufacture or distribute financial instruments are to take account of the rules in the Sourcebook as if they were guidance on the FCA's Principles for Businesses and other relevant rules

Key Requirements for Issuers/Manufacturers and Distributors

Governance arrangements

Both manufacturers and distributors must have product governance arrangements in place. These should aim to ensure that products are designed and distributed with the adequate consideration given at each stage to the characteristics, needs, and objectives of the identified target market.

Manufacturers must maintain, operate, and review a product approval process for each financial instrument before it is marketed or distributed to clients. This process must specify a target market and assess risks to that target market. It must also ensure that the strategy for distribution of a financial instrument is consistent with the identified target market. Manufacturers should also institute adequate systems and controls to manage any risks posed by the design process.¹⁷⁵

Distributors also have a wide range of obligations. They must understand any instrument they distribute, assess the compatibility of the instrument with the target market and the needs of the client, and ensure that a financial instrument is distributed only when it is in the best interests of the client to do so.¹⁷⁶

Both manufacturers and distributors must periodically review their governance arrangements. Such reviews, as well as initial development, must be monitored by their internal compliance function. They must also ensure that their management bodies have effective control over the product governance process, and that relevant staff members have the expertise to understand the features of the target market and the risks and characteristics of the financial instruments being manufactured or distributed.¹⁷⁷

Manufacturers and distributors must establish and maintain procedures and measures to ensure compliance with applicable conflict of interest requirements in connection with manufacture and distribution. Distributors must also establish procedures and measures to ensure that all other applicable rules (including those relating to disclosure, suitability, appropriateness, and inducements) are complied with when deciding the range of financial instruments to be distributed.¹⁷⁸

Firms are expected to comply with the product governance rules in a way that is proportionate as well as appropriate. In doing so, they should take into account the nature of the financial instrument in question and its target market.¹⁷⁹

Target market and distribution strategy assessments

Both distributors and manufacturers must identify the potential target market for each instrument, and distributors must also identify their distribution strategy.¹⁸⁰ In identifying the target market, manufacturers must reach a sufficiently granular level of analysis and must specify the types of clients that are within the target market and those that are not. In determining whether an instrument is compatible with the target market, manufacturers must examine whether the instrument's risk/reward profile is consistent with the target market, and whether the design of the instrument is driven by features that benefit the client and not by a business model that relies on poor client outcomes to be profitable. When a manufacturer does not engage in distribution conduct, its determination of whether the product is compatible with clients must be based on its theoretical knowledge and past experience of the instrument or similar instruments, the markets, and the needs of the client.¹⁸¹

174. Sourcebook, 1.3.1R.

175. Sourcebook, 3.2.3R–3.2.5R.

176. Sourcebook, 3.3.1R.

177. Sourcebook, 3.2.3R, 3.2.31R–3.2.33R, 3.3.16R, 3.3.20R–3.3.22R.

178. Sourcebook, 3.2.27R–3.2.30R, 3.3.18R.

179. Sourcebook, 3.1.2R.

180. Sourcebook, 3.2.8R and 3.3.11R.

181. Sourcebook, 3.2.8R–3.2.11R.

Distributors conducting their own target market analysis must use information obtained from manufacturers and information they have on their clients. Distributors should assess when they need additional information or training from manufacturers, and they should not distribute a financial instrument if they do not understand it sufficiently.¹⁸² Distributors should understand the financial strength of the manufacturer, and how efficiently and reliably the manufacturer will deal with the distributor or the end client at the point of sale and subsequently.¹⁸³ Distributors must also identify and assess the circumstances and needs of the clients they intend to focus on, to ensure that their clients' interests are not compromised as a result of commercial or funding pressures.¹⁸⁴

Product design and testing requirements

Manufacturers must undertake a scenario analysis of their financial instruments to assess the risk of poor outcomes for end clients, and the circumstances in which those risks might eventuate.¹⁸⁵ They must also consider whether the financial instrument may represent a threat to the stability of financial markets.¹⁸⁶ In conducting the scenario analysis, manufacturers must assess their financial instruments under negative conditions. The Sourcebook provides an illustrative list of such conditions, including where the market environment deteriorates, where the manufacturer experiences financial difficulties, and where demand for the instrument is much higher than anticipated.¹⁸⁷ Manufacturers must also consider the charges proposed for each instrument against the features of the target market and the instrument's return expectations (for example, where costs would equal, exceed, or remove almost all of the expected tax advantages linked to an instrument). Charging structures must also be assessed for transparency.¹⁸⁸

Information-sharing requirements between manufacturers and distributors

Manufacturers must make all appropriate information on an instrument, the product approval process, the target market, and appropriate distribution channels available to any distributors. In doing so, they may consider what information distributors already have, their likely level of knowledge and understanding, their information needs, and what form or medium would best meet those needs.

Manufacturers must also ensure that the information is of an adequate standard to enable distributors to understand and recommend the instrument properly. Manufacturers should make clear whether the information provided is intended for end consumer use.¹⁸⁹

To support the reviews carried out by manufacturers (which are discussed in greater detail in the next section), distributors must provide manufacturers with information on sales and the distributors' own reviews of the product, where appropriate. In determining when it will be appropriate to provide such information, distributors should have regard to the totality of the manufacturer's obligations. Such information should be shared if the manufacturer requests it.¹⁹⁰

Product review requirements

Manufacturers and distributors must regularly review their financial instruments, considering any event that could materially affect the potential risk to the identified target market. In doing so, both distributors and manufacturers must assess

- whether the instrument remains consistent with the needs, characteristics, and objectives of the identified target market; and
- whether the intended distribution strategy remains appropriate.

Additionally, manufacturers must assess

- whether the financial instrument is being distributed to the target market; and
- whether the financial instrument is reaching clients for whose needs, characteristics, and objectives it is not compatible.¹⁹¹

When carrying out these reviews, manufacturers should communicate contractual "breakpoints" to end consumers (such as the end of a long tie-in period that may have a material impact on the consumers that they could not reasonably be expected to recall or know about already). If the manufacturer does not know the identity of the end consumer, they should communicate these breakpoints to the distributor.¹⁹²

182. Sourcebook, 3.3.4G.

183. Sourcebook, 3.3.11G.

184. Sourcebook, 3.3.15R.

185. Sourcebook, 3.2.12R.

186. Sourcebook, 3.2.15R.

187. Sourcebook, 3.2.13R.

188. Sourcebook, 3.2.4R.

189. Sourcebook, 3.2.16R–3.2.18G.

190. Sourcebook, 3.3.30R–3.3.31R.

191. Sourcebook, 3.2.19R, 3.3.26R–3.3.27R.

192. Sourcebook, 3.2.21R.

If an event occurs that affects the potential risk or return expectations of the instrument, manufacturers must take appropriate action. This may include, for example, providing relevant information to distributors or consumers, changing the product approval process or the distribution process, changing the instrument, and stopping further issuance of the instrument.¹⁹³

Manufacturers must consider relevant factors (such as the complexity or innovative nature of investment strategies pursued) to determine how regularly to review their financial instruments. However, prior to reissue or relaunch of an instrument, they must review if they are aware of any event that could materially affect the potential risk to clients or the potential risk or return expectations of the instrument.¹⁹⁴

Distributors also have review obligations. If a distributor becomes aware that they have wrongly identified the target market for a financial instrument, or the financial instrument no longer meets the circumstances of the market, the distributor must take appropriate steps, including at least

- reconsidering the target market; and/or
- updating their product governance arrangements.¹⁹⁵

Applicable Penalties

The Sourcebook does not specify penalties for breach of the design and distribution rules but breach of any rules promulgated by the FCA can attract enforcement action, including the imposition of penalties, pursuant to powers the FCA has under the FSMA. The FCA's policies in relation to enforcement action are set out in its Enforcement Guide and its Decision Procedure and Penalties Manual. Chapter 6 of the Manual refers to the following five steps normally followed for determining penalties:

- Disgorgement: Where the FCA seeks to deprive a firm of the financial benefit derived directly from the breach.
- The seriousness of the breach: The FCA will determine a figure that reflects this, giving consideration to matters such as the amount of revenue generated by a

firm from the relevant product or business area and a percentage of that revenue that may form the basis of the penalty.

- Mitigating and aggravating factors: The FCA may increase or decrease the amount of the penalty by reference to various mitigating or aggravating factors.
- Adjustment for deterrence: If the FCA considers that the figure arrived at is insufficient for deterrence, it may increase the penalty. It will take into account the result of actions taken after previous breaches.
- Settlement discount: The FCA may seek to agree the amount of any financial penalty with the affected entity as part of agreeing other settlement terms.¹⁹⁶

Product Intervention Powers

The FSMA grants the FCA the power to make temporary or permanent product intervention rules prohibiting firms from engaging in certain types of conduct.¹⁹⁷ Temporary rules may be made before consultation where the FCA identifies a significant risk of detriment to consumers that requires prompt action.¹⁹⁸ The rules will have a maximum duration of 12 months, although the FCA may specify a shorter duration.¹⁹⁹ According to the FCA website, in practice such rules will allow the FCA to take actions including restricting the use of certain product features, requiring that a product not be promoted to some or all types of customers, or—in the most serious cases—requiring that a product not be sold altogether.²⁰⁰

The FCA has provided a policy statement in chapter 2 of the Sourcebook²⁰¹ setting out the circumstances in which it will exercise its product intervention power by making temporary rules. The chapter also provides guidance on certain aspects of the FCA's policy on permanent rules.

Extent of the rules the FCA may make

Under section 137D(2) of the FSMA, the FCA may prohibit authorized persons from

- entering into specified agreements or doing so without satisfying certain requirements specified by the FCA; and

193. Sourcebook, 3.2.24R.

194. Sourcebook, 3.2.25R–3.2.26R.

195. Sourcebook, 3.3.28R.

196. FCA Handbook of Rules and Guidance – Decision Procedure and Penalties Manual, 6.5–6.5A.

197. FSMA, section 137D.

198. FSMA, sections 138L (which also specifies some more general consultation exemptions for rule making) and 138M.

199. FSMA, section 138M, and Sourcebook, 2.14.1G.

200. FCA 2013.

201. As required by FSMA, section 138N.

- doing anything that would or might result in authorized persons entering into specified agreements or holding an interest in such agreements or doing so without satisfying certain requirements specified by the FCA.

In the event of a breach, the temporary product intervention rules may provide for agreements to be unenforceable, for the recovery of money or property, and for the payment of compensation for any loss sustained.²⁰²

The extent of any rules the FCA may make will generally depend on the type of intervention deemed necessary to address the issues identified. The FCA will have regard to whether the intervention will be a proportionate response to the perceived risk to consumers, competition issues, and market integrity issues. The rules may include requiring certain product features to be included, excluded, or changed; requiring amendments to promotional materials; the imposition of restrictions on marketing; or a ban on sales or marketing of a product in relation to all or some types of client.²⁰³

Considerations before making rules

The FCA will consider making product intervention rules where it identifies a risk of consumer detriment, a threat to market integrity, or ineffective competition arising from a particular product, type of product, or related practices. It will make temporary rules (importantly, without the need for consultation) where there is a need for prompt action in order to reduce or prevent these risks from eventuating.²⁰⁴ In making product intervention rules, the FCA will also consider²⁰⁵

- whether the proposed rules are appropriate and proportionate to the risks identified, supported by evidence, transparent in aim and operation, likely to be beneficial to consumers as a whole, and compatible with other applicable laws;
- the scale of detriment in the market and to individual consumers;
- the social context, including social issues that lead to detriment for particular vulnerable consumer groups;
- the market context;

- possible unintended consequences, such as any detriment caused by the rules or the timing of the intervention;
- any negative impact on competition;
- when making temporary product rules, the regulatory principles it must apply under section 3B of the FSMA, which include efficiency and economy, transparency, proportionality, sustainable growth, consumer responsibility, and senior management responsibility; and
- when making temporary product rules, the potentially deterrent effect on entry to the market and innovation.

Decisions to make any rules will be taken by the FCA Board, which will consider all the available relevant evidence, as well as the impact of the measure to be introduced by the rules.²⁰⁶

Process for making product rules

In making temporary product rules, the FCA will follow the process that it has outlined in the Sourcebook. Once initial proposals have been discussed, a paper will be prepared for a committee containing proposed temporary rules. The committee will either endorse the proposals or suggest amending them. If the committee decides that the proposals should go to the FCA Board, the paper will be taken to the next available FCA Board meeting.²⁰⁷ If there is sufficient time to do so, the FCA will generally seek the views of various panels. Before any rules are made (whether temporary or not), the FCA will consult the Prudential Regulation Authority.²⁰⁸ Rules will be published by the FCA with reasons for their introduction. They may also be reviewed by the FCA while they are in force. As a result of these reviews, where necessary, the FCA may revoke or amend a rule.²⁰⁹

The making of permanent rules would require the FCA to follow the rule-making process specified in the FSMA.²¹⁰

202. Sourcebook, 2.3.1G.

203. Sourcebook, 2.2.5G–2.2.6G.

204. Sourcebook, 2.5.1G–2.5.2G.

205. Sourcebook, 2.6.2G, 2.7.1G, 2.8G, 2.9G.

206. Sourcebook, 2.4.5G.

207. Sourcebook, 2.10G.

208. Sourcebook, 2.11G–2.12G.

209. Sourcebook, 2.13G.

210. See, among others, FSMA, sections 137E and 138I.



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