



PRODUCT APPROVAL GUIDELINES

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Product Approval Guidelines

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1. WHAT THESE GUIDELINES ARE ABOUT

- 1.1. These guidelines are intended to support the product development and distribution process within firms that issue retail structured financial products by clarifying the respective roles and responsibilities of the various parties involved in a manner that promotes the fair treatment of individual investors.
- 1.2. New financial products should be subject to a robust internal approval process that requires objective review and appropriate senior management sign-off before they are offered to retail investors. This process and the associated procedures should be detailed in a Product Approval Policy (see section 5 - Internal Controls).
- 1.3. AFMA recommends that members have in place a documented product approval framework which:
 - considers reputational risks¹ in the product development and sign-off process, and has arrangements in place to identify and respond to reputational risk issues;
 - has clear roles and responsibilities to demonstrate accountability for those involved in all aspects of the development and approval process;
 - has clear criteria about what constitutes a new product, and when a streamlined approval process may be used (for example, where the firm has previously issued a very similar product), or has a framework where such decisions are overseen by people separate from the business unit that will issue the product;
 - incorporates effective scrutiny and challenge;
 - has an effective product suitability framework;
 - manages any conflicts between the firm and the investor properly;
 - takes account of changes in the external environment; and
 - is subject to a robust review mechanism.
- 1.4. Firms should ensure that the product approval process allows for review and challenge by the risk, compliance and control functions.
- 1.5. Firms should review and update as appropriate the product approval process on a regular basis to ensure that it remains robust and fit for purpose.
- 1.6. Firms should only offer a financial product that represents a genuine investment opportunity for investors, although it may still be subject to risks.

¹ Reputational risks can include the risk to a product issuer's brand and reputation that may result where a product issuer does not take sufficient care in the development of a new product, or knowingly issues a product that is not designed to produce a beneficial outcome for a retail investor, and a retail investor experiences significant detriment as a result of having invested in the product.

2. APPLICATION OF THE GUIDELINES

- 2.1. These guidelines are designed to assist members of the Australian Financial Markets Association (AFMA) that issue structured financial products in Australia that are available to retail investors.
- 2.2. These guidelines generally relate to products that are dealt over the counter between the product issuer and the retail investor (either directly or through an intermediary)². These guidelines may also relate to an exchange-traded product to the extent that the issuer reasonably considers that the new product is more complex than other listed products which are generally considered to be “vanilla”.
- 2.3. Structured products are generally derivatives or other financial products that are designed to provide investors with targeted risk/return profiles. Structured financial products are generally a packaged investment strategy which combines a range of elements (which can include one or more of):
 - leverage;
 - a component of capital at risk;
 - an investment return and/or payment obligations which is contingent on or highly sensitive to changes in the value of underlying assets, indices, interest rates or cash flows;
 - a nominated level of capital protection at maturity.

3. ADOPTION OF THE GUIDELINES IS RECOMMENDED

- 3.1. AFMA recommends that its members incorporate these guidelines into their business processes.
- 3.2. These guidelines have been developed by AFMA in consultation with its members. These guidelines are intended to assist a financial market participant that issues structured financial products to retail investors (either directly, or indirectly through distribution networks provided by other financial services licensees) to ensure the issuer has appropriate policies and procedures in place for the approval of new financial products.
- 3.3. These guidelines do not replace statutory obligations that apply to persons who issue financial products to retail investors, and/or provide advice to retail investors about financial products.

² Some types of OTC products that are available to retail investors (eg. contracts for difference) are subject to specific ASIC regulatory guidance. Issuers of those products should adhere to that ASIC guidance.

- 3.4. AFMA is not a regulatory body and does not have supervisory or disciplinary powers. These guidelines have been developed as a mechanism to assist AFMA members to assess their internal product approval, manufacture and distribution processes, and to promote the fair treatment of investors.
- 3.5. AFMA will promote these guidelines to its members through appropriate forums, including publication on the AFMA website.
- 3.6. These guidelines will be reviewed periodically and at least once in every 12 month period.

4. REGULATORY FRAMEWORK

- 4.1. The regulatory regime that applies to issuers of financial products is set out in the *Corporations Act 2001* and the *ASIC Act 2001* (and supplemented by ASIC regulatory guidance) and the ASX Listing Rules.

5. INTERNAL CONTROLS

- 5.1. All relevant functions within an issuer should provide the infrastructure required to support the structured financial products issued by the issuer. At the concept approval stage of a new product, the issuer must ensure that products can be delivered and will operate in a manner that is consistent with the purpose for which the products were designed.
- 5.2. New structured financial products should be subject to a robust internal approval process that requires objective review and appropriate senior management sign-off before they are offered to retail investors. This process and the associated procedures should be detailed in a Product Approval Policy. The Product Approval Policy may comprise various policies which together cover the relevant subject matter.
- 5.3. **Product Approval Policy**
 - 5.3.1. Product issuers have a responsibility to provide information about the product that will enable an investor to make an informed decision about investment in the product.
 - 5.3.2. Investors in a structured financial product should be able to understand the product, including the risk and rewards of the investment, and be treated fairly in the marketing, sale and management of the product. A product issuer's product approval process should promote these outcomes by supporting:
 - the provision of clear, concise and effective disclosure to investors;
 - the effective management of key risks, including conflicts of interest; and
 - the consideration of the suitability of the product for the categories of investor to which it is marketed.
 - 5.3.3. This will help investors to set their own investment goals, to critically assess investment options (including the associated risks and rewards) and to stay informed about their investments. It may be appropriate for investors, especially those less familiar with investment concepts and financial products, to obtain advice and seek assistance from a professional financial adviser in relation to their investment activity.
 - 5.3.4. The Product Approval Policy process is not an alternative to, or a substitute for, the assessment of legal and regulatory requirements. However, the Policy should require confirmation that the necessary legal and regulatory inquiries and checks have been made and the outcomes are satisfactory.
 - 5.3.5. The Product Approval Policy should specify the business units within a firm and entities within a corporate group to which it applies. The corporate governance framework through which the product is reviewed and approved should reflect the scope of the policy's application.

5.3.6. The Product Approval Policy should provide guidance about what constitutes a new structured financial product for the purpose of a firm's internal product approval policy and procedures. If responsibility for determining whether a product is new resides within the business unit that will issue the product, the Product Approval Policy should provide for oversight of that decision-making process³.

5.3.7. A new product should include product types that have not been previously issued by the firm. In making a judgement on this, it is relevant to consider a range of factors including:

- whether a product of this type has previously been issued or offered by the issuer (including white labelling of another entity's product), or by another issuer;
- whether the product has been previously issued to a particular class of investor – for example, it has previously been offered to wholesale investors but not to retail investors⁴;
- whether modifications to existing products are substantive and should be treated as a new product;
- ensuring that small changes to products issued over time do not result in a substantive change in the nature of the product which may circumvent the product development and approval process; and
- whether the product involves significant new systems or operations requirements.

5.4. Reputational and business risk

5.4.1. Consideration of reputational risk should be integral to all stages of the product development and sign-off process. A firm should be able to demonstrate that it has arrangements in place to identify and respond to all reputational risk issues.

5.4.2. As part of the product sign-off process, the product approvers (which should include people who perform functions distinct from the business developing the new product) should have sufficient information to form the view that risks, including any reputational risk, associated with the product have been appropriately identified and mitigated (where necessary). This sign off process and procedures should be structured and documented to ensure that persons providing any sign off are made aware of the scope of their responsibility and act accordingly.

³ For example, this may occur through a diligence committee or other governance arrangements that the product issuer has in place.

⁴ If the product has not previously been issued to retail investors, it should generally be treated as "new".

5.4.3. Consideration should be given in the product sign-off process to reputational and business risks (in addition to those considered as part of the risk management process outlined below in the 'Product development and approval processes' section) having regard to current market and regulatory conditions, and investor sentiment towards new products, products with particular features, or products that are designed for a particular purpose.

5.5. Product development and approval processes

5.5.1. A number of measures must be undertaken as part of the product approval process. Details may vary between issuers, depending on the nature and scale of an issuer's business (eg. a firm may outsource its tax advice) --- however, the substance of the checks identified here should form part of the process.

5.5.2. The Product Approval Policy should ensure that roles and responsibilities in the process are clearly defined.

5.6. Business units

- A sound business case should exist for the product, which is based on its capacity to satisfy what are expected to be genuine client demands;
- The target market and the range of client segments for which the product would be suitable should be determined during the product design stage;
- The distribution strategy for the product should align with the target market for the product; and
- Product specific training and education facilities should be available to staff and other persons who will advise on or market the product.

5.7. Legal and compliance

- Confirmation should be given that the firm holds the necessary licensing requirements.
- Checks should be put in place to enable sign-off in relation to the adequacy of product disclosure materials (for example, consideration of whether product disclosure materials should include a description of the target market of the product, the risk profile, and the investment horizon).
- Specific consideration should be given to the identification of possible conflicts of interest related to the issue, distribution and ongoing management of the product and associated risks.
- There should be specific consideration of the legal nature of the product (eg. security, derivative or managed investment scheme, and whether it is bundled with other products) and if relevant, any implications for the issuer's licensing arrangements.
- The money laundering/terrorism financing risk of the products should be assessed,

including the distribution channels used, so that any changes to the AML/CTF risk profile of the issuer can be made at the time the product is developed.

5.8. Risk management

- Appropriate procedures should be put in place to monitor and manage risk consistent with the design of the product, including market risk, counterparty/credit risk, financing risk and operational risks.
- Specific consideration should be given to the adequacy of the pricing models and the management of pricing risks.

5.9. Operations and IT systems

- The systems requirements necessary to support the product should be assessed and the necessary measures put in place to support the product offering.
- The necessary testing of systems performance and integration should be conducted before the product is released to the market.

The personnel requirements (including staff training) necessary to support the product should be assessed and the necessary measures (eg call centre and website product support) to support the product offering should be identified.

5.10. Taxation

- The product should be subject to review by executives with relevant taxation experience (for example, within the firm's tax unit) having regard to the identification of any important tax implications of the product for the firm and its investors and the effective disclosure and management of any associated tax risks;⁵ and
- That review should consider whether it is necessary to:
 - obtain external advice on the tax implications of the product,
 - rely on relevant existing public rulings from the Australian Taxation Office (ATO), and/or
 - obtain a Product Ruling from the ATO.

⁵ The guide for tax intermediaries published by the Australian Taxation Office, "Good Governance and Promoter Penalty Laws", may be useful as a reference document for this purpose.

5.11. Product sign-off

5.11.1. The product approval process should be overseen by senior management in the firm and new products should receive internal sign-off incorporating, where appropriate, scrutiny and challenge (including of the product proposal), from:

- appropriately delegated local or regional management;
- the relevant business head;
- legal and compliance unit;
- risk management unit;
- accounting and finance unit;
- treasury operations; and
- the tax unit.

5.11.2. The product should not be released into the market until the mandated sign-offs have been given.

5.12. Post implementation

5.12.1. A register of new products approved under the policy and the current product manager for each product should be maintained.

5.12.2. The product manager should have responsibility for the ongoing management of the product within its lifecycle, including matters such as:

- the product distribution strategy remains consistent with that identified in the product design stage;
- the product is tracked and monitored to appropriately manage its risk profile;
- maintenance of product offering strategies, process enhancements and product disclosure; and
- provision of appropriate product training materials, amongst other things.

5.12.3. The product issuer should have monitoring capability within designated units to identify and respond to any relevant legislative, taxation and other changes that affect products offered by the issuer and to ensure any necessary adjustments are made, and disclosed to investors if required.

5.12.4. Procedures and systems should be in place to ensure that obligations to investors are monitored and carried out on an ongoing basis, and to review periodically that the product has been implemented as specified during the product approval process. Relevant procedures should allow for escalation to senior management.

- 5.12.5. The product issuer should have adequate post issue support arrangements in place to respond to investor requests and communicate with investors (as deemed appropriate by each issuer), and to deal with matters such as processing of early withdrawals or transfer of ownership.

- 5.12.6. The product issuer should review its complaints register on a regular basis and look for concerning patterns or trends about a particular product or the selling practices of a particular distributor.

6. SUITABILITY OF FINANCIAL PRODUCTS FOR THE TARGET MARKET

6.1. Suitability for the target market

6.1.1. Product suitability for the targeted market segment should be considered by the product manager and senior management at the product design stage.

6.1.2. The product should satisfy what is understood to be genuine client interests, and management of the offering should enhance the firm's relationship with its investors.

6.1.3. There are a number of factors that issuers should consider in determining the suitability of a product for the target market, including a combination of some or all of the following:

- Market research on the likely demand for the product;
- Distribution network feedback on the types of products that are likely to be taken up by investors, or that will address an identified client need;
- The likely performance of the product taking into account market conditions and other relevant economic factors to the extent these are reasonably known;
- The profile of investors in the target market (including for example, broad investment objectives which the product might satisfy, and broad characteristics of investors of the product); and
- The distribution channel and strategy that will be used to distribute the product, including the aids available to assist investors in obtaining the information they require to assess the product, and whether the product will be directly available to investors or through an adviser distribution model.

6.2. Complexity

6.2.1. Issuers should have close regard to the level of complexity of the product and whether an investor in the target market will be likely to be able to understand key elements including:

- the way in which the product operates;
- the fees and charges connected to the product;
- how the pay-off is derived;
- how to exit the product (and any penalties for exiting early); and
- the risks and returns associated with the product in a range of market conditions.

- 6.2.2. Consideration should be given to disclosure in the product disclosure documents about sensitivity analysis and the risks and outcomes for investors (for example, the likelihood of different scenarios occurring and the impact that this would have on the investment) in a way that will be meaningful and helpful to investors. Disclosure should be clear, concise and effective.

- 6.2.3. Where necessary, issuers should have arrangements in place to identify whether the complexity level of a product is such that an investor in the target market is less likely, or unlikely, to be able to understand the key elements outlined above.

7. DISTRIBUTION

7.1. Entering into distribution arrangements

- 7.1.1. A product issuer should decide whether their product is one where it would be preferable for investors to obtain advice before making an investment decision. If a structured product has complex features which are more difficult to explain to investors, issuers should be more cautious about distribution strategies which provide no advice or general advice only to investors. Issuers should be mindful of whether a typical retail investor will have a need for tailored financial advice considering the complexity of the product in developing its distribution strategy. Distributors should not be regarded as the end customer.
- 7.1.2. A distributor will ordinarily be a financial services licensee (such as a dealer group) or authorised representative of a licensee that interacts directly with a retail client. In some cases, but not all, the product issuer may also be the distributor of the product. The product issuer and distributor may be part of the same corporate group, or they may be completely separate entities who may (or may not) have a commercial arrangement to distribute the financial product. There is no industry wide standard form of such arrangements. The terms are negotiated between the parties.
- 7.1.3. The distribution structure means that it is often the distributor who interfaces with the individual investor as a client of the distributor. In these circumstances, product suitability is an important issue for distributors to consider, as this must be done in the context of information that is given by the client to the distributor. Distributors have a responsibility to independently assess the product and its suitability for the market segment they target as distributors. The issuer should make available to these distributors the materials that will enable them to understand the product they are to distribute and should consider undertaking education and accreditation of advisers who work for a distributor in connection with the product.
- 7.1.4. When entering into a distribution arrangement with a distributor, product issuers should consider whether the distributor is an appropriate distributor to place their products. The product issuer should conduct a “know your distributor” process. Matters which should be considered include:
- the distributor's business (the sales team and their experience selling structured products), size (capacity to implement the distribution strategy) and reputation;
 - sales practices and use of marketing materials;
 - whether the distributor provides any advice, general advice or personal advice to the relevant investors;

- the distributor's typical client type, and whether the distributor deals directly with the client, or via other intermediaries;
- where a distributor introduces investors to the product at seminars or through advertisements, whether those measures are appropriate for the target market and the product being offered;
- whether the distributor considers the suitability of a financial product on an individual investor basis or for a class of investor;
- the distributor's regulatory status and reputation; and
- any history of complaints against the distributor or other information that is relevant to the good standing of the distributor, to the extent this information can be obtained; and
- whether the distributor has arrangements in place so that its representatives have sufficient knowledge and understanding of the product to be able to give appropriate advice to investors.

7.1.5. The respective roles of the product issuer and the distributor should be well understood by each party, and appropriate. For example, if the product issuer provides a loan in connection with a financial product, the issuer should retain responsibility for assessing the investor's credit risk.

7.1.6. Notwithstanding the above, each party retains its own regulatory responsibilities, and the product issuer cannot be deemed to assume the regulatory obligations of the distributor, and vice versa. In particular, if a distributor provides advice to a retail client about investment in the product, then the distributor, and its representatives as the case may be, is responsible for compliance with the relevant obligations in Chapter 7 of the Corporations Act in relation to the provision of personal advice.

7.2. Ongoing review of distribution arrangements

7.2.1. Depending on the distribution model in place and the nature of the relationship between the product issuer and the distributor, the issuer should review distribution arrangements on a periodic basis.

7.2.2. Under the terms of a distribution arrangement, the product issuer should obtain information from the distributor about the nature of the investors who acquire the product and the circumstances in which the product is recommended to investors by the distributor. This information will assist the issuer to ensure that the product is meeting the needs of the target market for which it was designed, to manage the performance of the product over time and ongoing reputational risk for the issuer relating to the distributor.

- 7.2.3. The terms of a distribution arrangement should also oblige a distributor to pass on information and complaints about the product (as opposed to complaints about advice in relation to the product, for which the distributor is responsible) to the product issuer in a timely way. Product disclosure statements also contain information about how an investor can make a complaint.
- 7.2.4. Issuers should act on their reviews of distributors, and such action could include:
- amending consumer or adviser literature;
 - providing additional training for distributors;
 - limiting distribution to specific channels;
 - ceasing to use a particular distribution channel; and/or
 - escalating issues to senior management of the issuer.
- 7.2.5. Product issuers should pay attention to any abnormal sale patterns or unusual requests from distributors. Where the issuer becomes aware that a product is being distributed in a manner that is not consistent with the purpose or target market for which it was designed, then the issuer should take steps to correct this with the distributor as soon as practicable. Product issuers should have particular regard to indicators of poor selling practices, and other behaviours that are out of the ordinary or not reflected across the issuer's distribution network.
- 7.2.6. Strong sales should not be seen necessarily as a positive measure that investors are being treated fairly. Higher than expected sales might in fact be an indication that a product is being sold beyond the target market it is intended for.
