



**ASIC**

Australian Securities & Investments Commission

## REPORT 400

# Response to feedback on REP 384 Regulating complex products

July 2014

### **About this report**

This report highlights the feedback received on Report 384 *Regulating complex products* (REP 384) in relation to the risks posed to retail investors by complex products, and the mitigation of those risks. The report also details ASIC's response to the feedback received.

### About ASIC regulatory documents

In administering legislation ASIC issues the following types of regulatory documents.

**Consultation papers:** seek feedback from stakeholders on matters ASIC is considering, such as proposed relief or proposed regulatory guidance.

**Regulatory guides:** give guidance to regulated entities by:

- explaining when and how ASIC will exercise specific powers under legislation (primarily the Corporations Act)
- explaining how ASIC interprets the law
- describing the principles underlying ASIC's approach
- giving practical guidance (e.g. describing the steps of a process such as applying for a licence or giving practical examples of how regulated entities may decide to meet their obligations).

**Information sheets:** provide concise guidance on a specific process or compliance issue or an overview of detailed guidance.

**Reports:** describe ASIC compliance or relief activity or the results of a research project.

### Disclaimer

This report does not constitute legal advice. We encourage you to seek your own professional advice to find out how the Corporations Act and other applicable laws apply to you, as it is your responsibility to determine your obligations.

This report does not contain ASIC policy.

# Contents

|          |  |           |
|----------|--|-----------|
| <b>A</b> | <b>Overview</b> .....  | <b>4</b>  |
| <b>B</b> | <b>What is a complex product?</b> .....                      | <b>6</b>  |
|          | Structures and features of complex products .....            | 6         |
| <b>C</b> | <b>Product development</b> .....                             | <b>7</b>  |
|          | Key risk 1: Poorly designed products .....                   | 7         |
| <b>D</b> | <b>Product distribution</b> .....                            | <b>9</b>  |
|          | Key risk 2: Distribution channels .....                      | 9         |
|          | Key risk 3: Disclosure .....                                 | 10        |
|          | Key risk 4: Advertising .....                                | 12        |
|          | Key risk 5: Access to general, independent information ..... | 13        |
| <b>E</b> | <b>Point of sale</b> .....                                   | <b>15</b> |
|          | Key risk 6: Financial advice .....                           | 15        |
|          | Key risk 7: Non-advised sales .....                          | 16        |
| <b>F</b> | <b>Post sale</b> .....                                       | <b>17</b> |
|          | Key risk 8: Ongoing product information .....                | 17        |
|          | <b>Appendix: List of non-confidential respondents</b> .....  | <b>19</b> |
|          | <b>Key terms</b> .....                                       | <b>20</b> |
|          | <b>Related information</b> .....                             | <b>22</b> |

## A Overview

- 1 In Report 384 *Regulating complex products* (REP 384),<sup>1</sup> we:
  - (a) outlined the risks posed to retail investors<sup>2</sup> by complex products at each stage of the product life cycle;
  - (b) set out our recent and current work on complex products; and
  - (c) identified opportunities for further work.
- 2 We also invited feedback on the issues raised in REP 384—in particular, we sought your views on:
  - (a) the risks posed to investors by complexity in financial products, and the extent of those risks; and
  - (b) the options for mitigating these risks, including the opportunities for further work identified in the report.
- 3 This report highlights the feedback received on REP 384 and our responses to this feedback.
- 4 This report is not meant to be a comprehensive summary of all responses received. We have limited this report to the key issues.
- 5 For a list of the non-confidential respondents to REP 384, see the appendix. Copies of the submissions are on the ASIC website at [www.asic.gov.au/reports](http://www.asic.gov.au/reports) under REP 384.

## Feedback received

- 6 We received nine responses to REP 384—from an individual, a stock exchange, a stockbroking business, industry associations, academics and financial advisory businesses. We are grateful to respondents for taking the time to send us their comments.
- 7 The submissions received commended ASIC for focusing on the risks posed to investors by complex products, and for publishing REP 384.
- 8 Generally, the submissions acknowledged the risks posed by complex products to investors, and were supportive of both:
  - (a) our recent and current work on complex products; and

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<sup>1</sup> REP 384 was published on 31 January 2014, with feedback requested by 31 March 2014.

<sup>2</sup> References to ‘investors’ in this report mean ‘retail investors’.

- (b) the proposal that, where we identify issues related to the development or distribution of particular complex products, we will work with industry to address those issues.
- 9 Respondents also suggested additional approaches to mitigating the risks posed by complex products.
- 10 Reflecting the risks identified in REP 384, the main issues raised by respondents related to:
- (a) defining what is a ‘complex product’;
  - (b) product design;
  - (c) product distribution;
  - (d) disclosure;
  - (e) advertising;
  - (f) access to general, independent information;
  - (g) financial advice;
  - (h) non-advised sales; and
  - (i) provision of ongoing information.

## ASIC’s response

- 11 Our responses take into account the Government’s objective of reducing the regulatory burden for individuals, businesses and community organisations; the current moratorium on new financial regulation; and the Financial System Inquiry<sup>3</sup> and ASIC’s submission to this inquiry.<sup>4</sup> Our responses include:
- (a) continuing our current work (e.g. our use of risk-based surveillance to assess compliance with disclosure and advertising obligations);
  - (b) encouraging industry-led initiatives that address the risks outlined in REP 384 (e.g. our work with the Australian Financial Markets Association (AFMA) to develop principles relating to retail structured products); and
  - (c) monitoring the outcome of the Financial System Inquiry.

<sup>3</sup> The Financial System Inquiry is charged with examining how the financial system can be best positioned to meet Australia’s evolving needs and support Australia’s economic growth. It will publish an interim report in mid-2014, setting out initial findings and seeking public feedback. A final report is to be provided to the Treasurer by November 2014. For more information, see <http://fsi.gov.au/>.

<sup>4</sup> See Media Release ([14-071MR](#)) *ASIC’s submission to the 2014 Financial System Inquiry* (8 April 2014).

## B What is a complex product?

### Key points

This section outlines the feedback on the approach taken in REP 384 to identifying complex products, and ASIC's response to that feedback.

### Structures and features of complex products

- 12 In REP 384, we identified product structures and/or features that are inherently more likely to make a product complex. We set out a non-exhaustive list of products that we currently consider to be complex.
- 13 The report specifically acknowledged that being more complex does not necessarily mean that a product is more risky, and that a relatively simple product can still pose a high degree of risk.

### Stakeholder feedback

- 14 Generally, stakeholders who provided feedback on this issue:
- (a) agreed with the proposition that complexity in financial products may lead investors to misunderstand the nature of the product and its risks;
  - (b) acknowledged the difficulty in defining what is a 'complex product'; and
  - (c) supported the flexible approach to identifying complex products adopted in REP 384.

#### *ASIC's response*

We will continue to use a flexible approach to identifying complex products that is based on our assessment of whether products have structures and/or features that are inherently more likely to make them complex.

In particular, we are interested in the relative complexity of products. Relative complexity is determined by considering complexity that has a potential negative impact on the investor (relevant complexity) in the context of how complex investors perceive the product to be. Generally, the risk is greatest when investors perceive a particular product as simple when in fact it has a complex structure and/or features that may have an impact on its performance.

## C Product development

### Key points

This section outlines the feedback on REP 384 relating to the risks posed to investors by complex products at the product development stage, and the mitigation of those risks.

It covers ASIC's response to this feedback, and our approach to mitigating the risk that poorly designed products enter the market and are offered to retail investors.

### Key risk 1: Poorly designed products

- 15 In REP 384, we identified that a key risk posed to investors by complex products at the product development stage is that products that are poorly designed enter the market and are offered to retail investors.
- 16 The report also noted that ASIC's regulation of the product development stage has been targeted at specific issues and products (e.g. our work with AFMA to develop principles for its members to guide the product development process for retail structured products).
- 17 REP 384 noted that:
- (a) where ASIC identifies issues relating to the development of particular complex products, we will work with industry to address those issues; and
  - (b) there is also scope, if necessary, for ASIC to issue guidance in the future on our expectations of product issuers when developing complex products.

### Stakeholder feedback

- 18 Overall, respondents were supportive of our proposed approach of working with industry where we identify issues relating to the development of particular complex products.
- 19 Two submissions supported an industry-led approach, rather than a regulatory approach, to address issues that arise at the product development stage. Two further submissions, while also supportive of an industry-led response, suggested that additional regulation of product issuers may be required to effectively mitigate the risk of poorly designed products.

*ASIC's response*

We encourage industry to take the initiative in the development of product development standards, and we will look for opportunities to work with industry to achieve robust industry-led outcomes.

We do not propose at this stage to issue guidance on our expectations of product issuers when developing complex products.

In our submission to the Financial System Inquiry, we noted that intervening in the way products are designed and developed is one of the regulatory options available for improving the quality of products entering the market. We will monitor the outcome of the inquiry on this issue.



## D Product distribution

### Key points

This section outlines the feedback on REP 384 relating to the risks posed to investors by complex products during the product distribution stage, and the mitigation of those risks.

It covers ASIC's response to this feedback, and our approach to mitigating the risks that:

- inappropriate distribution channels are used for offering complex products to investors;
- disclosure is not clear, concise and effective;
- advertising is misleading or deceptive; and
- investors do not have access to general, independent information on complex products.

### Key risk 2: Distribution channels

- 20 In REP 384, we identified that a key risk posed to investors by complex products at the product distribution stage is that inappropriate distribution channels are used for offering complex products to investors.
- 21 REP 384 noted that:
- (a) where ASIC identifies issues relating to the way that product issuers select distribution channels for particular complex products, we will work with industry to address those issues; and
  - (b) there is also scope, if necessary, for ASIC to issue guidance on our expectations of product issuers when selecting distribution channels for complex products.

### Stakeholder feedback

- 22 Three submissions suggested that the distribution of complex products should be allowed only if financial advice<sup>5</sup> has been provided. These submissions were based on the premise that the risks to investors are greater in non-advised channels where investors are more likely to make decisions without having access to, or taking into account, all the relevant information.
- 23 One submission did not agree with the premise that selling through an adviser is intrinsically safer for investors than investing without professional advice. The submission noted that both approaches can lead to good and bad

<sup>5</sup> In this report, 'financial advice' means personal advice given to retail investors.

outcomes, and suggested that the regulatory system should provide adequate means to protect investors from the risks associated with complex products regardless of whether or not the investor has received financial advice.

- 24 One submission suggested that there may be merit in restricting the sale of some types of products to sophisticated investors (and also reviewing how sophisticated investors are defined in the *Corporations Act 2001*).

#### *ASIC's response*

As noted in REP 384, we encourage industry to take the initiative in the development of standards relating to the selection of distribution channels for complex products by product issuers, and we will look for opportunities to work with industry to achieve robust industry-led outcomes.

We do not propose at this stage to issue guidance on our expectations of product issuers when selecting distribution channels for complex products. However, we will take into account how entities select distribution channels for their products as part of our risk-based approach to surveillance.

In our submission to the Financial System Inquiry, we suggested some ideas to consider to influence product distribution and reduce the risk of products being mis-sold. These included:

- requiring financial advice to be provided before products are sold;
- requiring products to be issued or sold through particular channels (e.g. some complex products only sold to retail investors through advisers);
- requiring products to be marketed in a particular way, or restricted to particular types of investors; and
- requiring issuers or other intermediaries that provide products directly to investors to carry out suitability tests.

We will monitor the outcome of the inquiry on this issue.

### **Key risk 3: Disclosure**

- 25 In REP 384, we identified that a key risk posed to investors by complex products is that complexity can increase the difficulty of describing a product in a clear, concise and effective manner, and that this could also increase the difficulty investors face in understanding a product's key features and the risk–reward trade-off associated with them.

26 REP 384 noted that:

- (a) ASIC has issued a range of guidance aimed at enhancing the quality of disclosure, including for products that are likely to be complex and difficult to explain;

- (b) we will continue to take a risk-based approach when conducting surveillances targeting product disclosure; and
- (c) we will consider whether there is scope to require, and the desirability of requiring, disaggregated cost and value disclosure to investors.

### Stakeholder feedback

- 27 Two submissions considered the proposal to require product issuers to provide disaggregated cost and value disclosure to investors. One was not supportive, noting that it would be difficult for issuers to provide and would be confusing for investors. The other supported the proposal, in principle, but acknowledged that it would be difficult to implement in practice.
- 28 Four submissions made suggestions for improving disclosure relating to complex products, including requiring the disclosure to include:
- (a) a one-page summary document;
  - (b) compulsory warnings and links to ASIC's MoneySmart website;
  - (c) a stand-alone risk awareness statement; and
  - (d) worked examples of the best-case and worst-case scenarios.
- 29 One submission suggested that all Product Disclosure Statements (PDSs) should be required to be lodged with ASIC.
- 30 Another submission suggested that disclosure could be improved if product issuers and research houses provided advisers and investors with reports which contemplate the usefulness and suitability of products for retail clients, explain the operation of the products' complex features, and highlight the factors affecting risk, liquidity and reward.
- 31 One respondent noted that integrating competition into the policies implemented by ASIC was an option for influencing behaviour in a way that would best serve the interests of end consumers. Disclosure for complex products was identified by the respondent as lending itself to this approach—that is, a regulatory approach that encourages firms to compete with each other can drive the delivery of enhanced product information.

#### *ASIC's response*

We will continue to take a risk-based approach when conducting surveillances targeting product disclosure.

In our submission to the Financial System Inquiry, we identified some limitations on disclosure, particularly in relation to complex products. We also identified some ways to improve the presentation of information, such as:

- providing information in different forms and channels, including using new media (e.g. to break down complex

information into a manageable scale, require active participation and test understanding); and

- giving prompts at the point of decision making that are designed to align behaviour with a particular policy goal.

We will monitor the outcome of the inquiry on this issue.

Treasury also identified disclosure as an area for the inquiry to consider. We will pass on to Treasury the feedback received on options for improving disclosure so that Treasury may take this into account in any future work it does on disclosure.<sup>6</sup>

In our submission to the inquiry, we also noted that a requirement to formally consider the effect of our decision making on competition would drive a greater focus on the long-term benefits for the end users of the financial system. We submitted that the inquiry should consider recommending that the *Australian Securities and Investments Commission Act 2001* (ASIC Act) be amended to include a competition objective in addition to ASIC's existing statutory objectives. We will monitor the outcome of the inquiry on this issue.

We do not propose at this stage to require disaggregated cost and value disclosure to investors. However, as the MySuper changes to disclosure of fees and costs for superannuation are implemented, we will review existing ASIC guidance and closely monitor disclosure with a view to identifying and addressing any emerging gaps and inconsistencies.

## Key risk 4: Advertising

- 32 In REP 384, we identified that a key risk posed to investors by complex products is that advertisements for these products may not fairly represent a product's key features and risks, thereby creating unrealistic expectations for investors.
- 33 REP 384 noted that:
- ASIC has issued guidance aimed at helping promoters comply with their legal obligations when advertising financial products and services (see Regulatory Guide 234 *Advertising financial products and services (including credit): Good practice guidance* (RG 234)); and
  - we will continue to take a risk-based approach when conducting surveillances targeting advertising.

<sup>6</sup> In its submission to the Financial System Inquiry, Treasury suggested that: 'In forming a view on cost-effective approaches to promoting confident and informed investors, the Financial System Inquiry should also consider the scope for promoting market solutions by redesigning disclosure requirements for the digital age to enable growth of information intermediaries that can apply expertise in presenting information in an effective and digestible way'.

## Stakeholder feedback

- 34 One submission commented on the mitigation of the risks associated with advertising complex products, suggesting that regulations could be tighter (e.g. requiring advertisements to include risk warnings).

### *ASIC's response*

In our submission to the Financial System Inquiry, we noted that: '[A]n area of significant focus for ASIC is on advertising. Investors and financial consumers can be heavily influenced by advertisements for financial products and services'.

We will continue to take a risk-based approach when conducting surveillances targeting advertising. In July 2013, we established a promotional materials group (involving seven separate ASIC teams) to ensure consistency in the use of ASIC's new Australian consumer law powers,<sup>7</sup> and to further develop ASIC's knowledge and expertise in relation to misleading advertising and conduct.

We do not propose at this stage to amend our existing guidance on advertising.

## Key risk 5: Access to general, independent information

- 35 In REP 384, we identified that a key risk posed to investors by complex products at the product distribution stage is that investors do not have access to general, independent information on complex products.
- 36 REP 384 noted that:
- (a) ASIC will continue to provide online information and tools on complex products; and
  - (b) ASIC has provided guidance, which was updated in December 2012, to providers of financial product research on our expectations in relation to research quality, transparency, methodology, and managing conflicts of interest (see Regulatory Guide 79 *Research report providers: Improving the quality of investment research* (RG 79)), and we will assess compliance with RG 79 through targeted surveillances.

## Stakeholder feedback

- 37 One submission specifically noted the usefulness of ASIC's MoneySmart website as a tool for investors, and suggested that ASIC could promote it further to encourage its use by investors.

<sup>7</sup> The Australian Consumer Law was passed as the *Trade Practices Amendment (Australian Consumer Law) Act (No.1) 2010*, which amends the ASIC Act. As part of these reforms, ASIC also has new enforcement and consumer redress powers. These new protections and remedies will assist us to perform our role in promoting the confident and informed participation of consumers and investors in the financial system.

*ASIC's response*

We continue to promote our MoneySmart website, which is now visited by around 440,000 Australians per month.

We will continue to provide information on complex products to investors through the MoneySmart website. For example, we recently updated information on MoneySmart to help investors understand the risks and complexities of hybrid securities. We have also developed a quiz for investors to help them comprehend the terms of hybrid securities and to encourage them to be fully informed before they invest.

We will consider whether further tools can be made available which can assist investors to understand the range of risks associated with complex products.

We will assess industry compliance with RG 79 through targeted surveillances.

## E Point of sale

### Key points

This section outlines the feedback on REP 384 relating to the risks posed to investors by complex products at the point of sale, and the mitigation of those risks.

It covers ASIC's response to this feedback, and our approach to mitigating the risks that:

- investors do not get appropriate financial advice on complex products; and
- investors who acquire complex products without appropriate financial advice may not fully understand the nature of the product.

### Key risk 6: Financial advice

38 In REP 384, we identified that a key risk posed to investors by complex products is that they may receive poor quality financial advice which can result in a poor outcome.

39 REP 384 noted that ASIC generally takes a risk-based approach to monitoring financial advice, with surveillances often undertaken as part of a thematic review of a particular type of product.

#### Stakeholder feedback

40 Two submissions commented on the risks posed to investors by poor quality financial advice.

41 Both of these submissions noted that these risks relate to complex products being mis-sold through general advice models (where the advice is limited to information about the product and does not take into account the specific objectives, needs and circumstances of the client).

42 One of the submissions also noted that two emerging trends in the financial advice industry heighten the risk to investors at the point of sale:

- (a) brokerage firms seeking to cull clients with portfolios below a certain threshold; and
- (b) the prioritisation of client acquisition and revenue over the quality of advice.

#### *ASIC's response*

As noted in REP 384, we will continue to take a risk-based approach when conducting surveillances targeting financial advice.

## Key risk 7: Non-advised sales

- 43 In REP 384, we identified that a key risk posed to investors by complex products is that they may receive no financial advice at all, which can result in an ill-informed selection of a product.
- 44 REP 384 noted that:
- (a) ASIC has released guidance in the past with disclosure benchmarks—for example, for over-the-counter contracts for difference (OTC CFDs), guidance included a benchmark on the issuer’s responsibility to have in place a client qualification policy that tests prospective clients’ understanding of the features and risks of OTC CFDs before they begin to trade (see Regulatory Guide 227 *Over-the-counter contracts for difference: Improving disclosure for retail investors* (RG 227)); and
  - (b) we will explore the potential for using investor self-assessment tools to assist investors in testing their understanding of particular products before investing.

### Stakeholder feedback

- 45 Two submissions supported the development of investor self-assessment tools by product issuers.
- 46 One submission suggested that the client qualification policy should be mandatory for CFDs and should extend to all complex products.

#### *ASIC’s response*

We are exploring the potential for financial product issuers to develop, on a voluntary basis, investor self-assessment tools.

Initially, the focus of this work will be on exempting issuers from the shorter PDS regime for simple managed investment schemes if they give investors a key facts statement, together with an investor self-assessment tool for investors to apply their knowledge and test their understanding of the issues outlined in the key facts statement if they choose to.

We are also monitoring overseas developments in relation to the use of investor self-assessment tools, including whether they are applied as a mandatory prerequisite to issuing a financial product.



## F Post sale

### Key points

This section outlines the feedback on REP 384 relating to the risks posed to investors by complex products at the post-sale stage, and the mitigation of those risks.

It covers ASIC's response to this feedback, and our approach to mitigating the risk that investors do not receive ongoing product information, which is essential for making appropriate trading decisions.

### Key risk 8: Ongoing product information

- 47 In REP 384, we identified that a key risk posed to investors by complex products is that they may not receive ongoing product information, which is essential for making appropriate trading decisions.
- 48 REP 384 noted that:
- (a) ASIC has provided specific disclosure guidance for various complex products, which has included requirements to provide ongoing information about the performance of a product (e.g. Regulatory Guide 240 *Hedge funds: Improving disclosure* (RG 240));
  - (b) where we identify issues relating to the provision of post-sale information for particular complex products, we will work with industry to address those issues; and
  - (c) there is also scope, if necessary, for ASIC to issue further guidance in the future on our expectations of product issuers in relation to the provision of time-critical post-sale information about complex products.

### Stakeholder feedback

- 49 One submission noted that, while exchange-traded options and CFDs are already appropriately regulated in terms of post-sale statements and reporting, more could be required of product issuers in relation to the provision of time-critical post-sale information for other complex products. Such information could include disclosing information about events that occur in the life of a product that affect its valuation.
- 50 One submission noted that the primary risk posed to investors in OTC CFDs was that client money may not be segregated and protected. This means that OTC CFD providers have the ability to use client funds for hedging purposes, in lieu of their own funds, placing those retail funds at risk.

*ASIC's response*

We encourage industry to take the initiative in the development of standards in relation to the provision of post-sale information to investors, and we will look for opportunities to work with industry to achieve robust industry-led outcomes.

We do not propose at this stage to issue guidance on our expectations of product issuers in relation to the provision of post-sale information about complex products.

We have raised with Treasury the importance of segregating client money, and we will continue to work closely with Treasury on this issue.

## Appendix: List of non-confidential respondents

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- Australian CFD Forum
  - Financial Planning Association of Australia
  - Melbourne Law School, University of Melbourne
  - UTS Business School, University of Technology, Sydney
  - Wilkins, Richard
-

## Key terms

| Term                | Meaning in this document  |
|---------------------|---|
| AFMA                | Australian Financial Markets Association  |
| ASIC                | Australian Securities and Investments Commission  |
| ASIC Act            | <i>Australian Securities and Investments Commission Act 2001</i>  |
| CFDs                | Contracts for difference  |
| client              | A retail client as defined in s761G of the Corporations Act and Div 2 of Pt 7.1 of Ch 7 of the Corporations Regulations 2001  |
| complex products    | See Table 1 in REP 384 for a description of product structures and/or features that are inherently more likely to make a product complex, and Table 4 in REP 384 for a list of products that we currently consider to be complex  |
| Corporations Act    | <i>Corporations Act 2001</i> , including regulations made for the purposes of that Act  |
| financial advice    | Personal advice given to retail investors   |
| financial product   | A facility through which, or through the acquisition of which, a person does one or more of the following: <ul style="list-style-type: none"> <li>• makes a financial investment (see s763B);</li> <li>• manages financial risk (see s763C);</li> <li>• makes non-cash payments (see s763D)</li> </ul> <p>Note: This is a definition contained in s763A of the Corporations Act: see also s763B–765A.</p> |
| investors           | Retail investors  |
| OTC                 | Over the counter  |
| personal advice     | Financial product advice that is given or directed to a person in circumstances where the provider of the advice has considered one or more of the person's objectives, financial situation and needs, or a reasonable person might expect the provider to have done so <p>Note: See s766B(3) of the Corporations Act for the exact definition.</p>   |
| point of sale       | The stage in a product's life cycle where the investor is recommended or invited to acquire the product. It is typically the point at which advice (if any) is given, and disclosure is provided if it has not been seen before   |
| post sale           | The period after a product is acquired by the investor  |
| product development | The stage in a product's life cycle involving the design and origination of products  |

| Term                               | Meaning in this document  |
|------------------------------------|---|
| Product Disclosure Statement (PDS) | <p>A document that must be given to a retail client in relation to the offer or issue of a financial product in accordance with Div 2 of Pt 7.9 of the Corporations Act</p> <p>Note: See s761A for the exact definition.</p>  |
| product distribution               | <p>The stage in a product's life cycle where the product travels from issuer to investor</p>  |
| product life cycle                 | <p>Includes the development and distribution of products, the sale of products to investors and post-sale issues</p>  |
| REP 384 (for example)              | <p>An ASIC report (in this example numbered 384)</p>  |
| RG 79 (for example)                | <p>An ASIC regulatory guide (in this example numbered 79)</p>   |
| surveillance                       | <p>A surveillance refers to activities where ASIC gathers and analyses information to test either a targeted sample of the regulated population, or a specific entity, transaction or product, for compliance with regulatory requirements or best practice standards</p> |

## Related information

### Headnotes

advertising, complex products, disclosure, financial advice, key facts statement, key risks, non-advised sales, point of sale, post sale, product development, product distribution, product information, risk-based approach, self-assessment tools

### Regulatory guides

*RG 79 Research report providers: Improving the quality of investment research*

*RG 227 Over-the-counter contracts for difference: Improving disclosure for retail investors* *RG 234 Advertising financial products and services (including credit): Good practice guidance*

*RG 240 Hedge funds: Improving disclosure*

### Legislation

ASIC Act

*Trade Practices Amendment (Australian Consumer Law) Act (No.1) 2010*

Corporations Act

### Reports

REP 384 *Regulating complex products*

### Media releases

14-071MR *ASIC's submission to the 2014 Financial System Inquiry*,  
8 April 2014

### Other

Financial System Inquiry, website, <http://fsi.gov.au>