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RG 97 for direct property fund PDSs - what you need to know

Background

In December 2014 ASIC issued class order 14/1252 (**CO 14/1252**) which modifies Schedule 10 to the *Corporations Regulations* 2001 (Cth) (**Schedule 10**), the fee and cost disclosure requirements for PDSs and periodic statements for superannuation[1] products and managed investment products. CO 14/1252 was updated by ASIC Instruments 2015/876, 2016/1224, 2017/65 and 2017/664.

In November 2015, ASIC issued Regulatory Guide 97 *Disclosing fees and costs in PDSs and periodic statements* RG 97. RG 97 was updated in March 2017.

This article provides a high level overview of the key concepts that direct property fund managers need to be aware of in completing the fees and costs section of their PDSs.

Timing

PDSs issued on or after 1 February 2017 had to comply with the CO 14/1252 unless the issuer had met the conditions to take advantage of the extension of the transition period to 30 September 2017 set out in [CO 14/1252].

Indirect costs

The most significant change to Schedule 10 is the introduction of indirect costs for managed investment products. Indirect costs must be calculated and disclosed as part of management costs.

Indirect costs means any amount that the issuer knows, reasonably ought to know or, where this is not the case, may reasonably estimate will directly or indirectly reduce the return on the product or option that is paid from, or the amount or value of, the income of or property attributable to:

a. the product or option; or

b. an 'interposed vehicle' (see below) in or through which the property attributable to the product or option is invested.

Other than costs relating to derivative financial products (discussed below), an amount incurred in an interposed vehicle needs to be included as an indirect costs only if the amount had it been paid out of the fund, would have been a management cost. The intent is for the same total fees and costs to be disclosed for the fund whether an amount is paid out of an interposed vehicle or the fund.

If the amount is not known, or could not reasonably be known, the issuer must reasonably estimate the indirect costs. If an estimate is used, it must be clearly designated as an estimate.

In completing the example of annual fees and costs, a typical ongoing amount within the range of such fees must be used. However, except for new products, when the PDS is available during a financial year, indirect cost amounts and the indirect cost ratio should be calculated based on the indirect costs paid in the previous financial year, and the indirect cost ratio should be calculated based on the total average net assets for the relevant financial year. This does not apply when preparing a PDS that has not been offered for at least 11 months before the end of the previous financial year. In that case, at the time the PDS is prepared the issuer must reasonably estimate the indirect costs that will apply for their current financial year, adjusted to reflect a 12-month period.

Interposed Vehicles

An interposed vehicle [2] is a body, trust or partnership that meets either the assets test or the PDS test and is not excluded under the platform test.

An entity is also an interposed vehicle if:

a. the PDS for the product or any other information issued refers to "property", "real estate" or "land" or similar terms in the description of the product or investment option or as one of the assets (relevant asset) in which investment may be made under the product or investment option; and

b. real property or an interest in land to which the reference relates is directly or indirectly held by or through the entity.

An entity is not an interposed vehicle as set out in the preceding paragraph if both the following are satisfied:

c. the reference in the PDS or other information is merely part of a reference to an entity (whether specified or not) that directly or indirectly invests in real property or interests in land or to physical infrastructure with respect to an infrastructure entity;

d. a retail client who has read the PDS or other information could not reasonably believe that the product or investment option or the relevant asset may be intended for persons predominantly intending to benefit from increases in the value of, or returns from holding, real property or an interest in land other than physical infrastructure with respect to an infrastructure entity.

An entity is also an interposed vehicle in relation to a product or investment option if:

e. the PDS or any other information issued refers to the product as being directly or indirectly invested in or through an entity (whether specified or not) other than an infrastructure

[1] A number of the concepts described in this article apply differently to superannuation funds than they do to managed investment products

[2] The definition is more extensive that set out in this article

entity which the issuer believes has a majority of its assets invested in physical infrastructure with respect to an infrastructure entity; and

f. the reference relates to the entity.

Notwithstanding the preceding paragraph an entity is not an interposed vehicle if:

g. either of the following is satisfied:

    i. the entity is listed;

    ii. the issuer of the securities or financial products of the entity has applied, or stated in a regulated disclosure that they will apply, for listing; and

h. the securities or financial products of the entity are, or are to be, held under an investment strategy for the product or investment option that:

    i. relates to, or is publicly measured by the responsible person by reference to, a widely used index (reference index); and

    ii. is a strategy of holding directly or indirectly securities or financial products:

    iii. of entities that satisfy paragraph (g) above; and

    iv. that represent at least 80% by value of the net assets attributable to the investment strategy; and

i. the value of all the securities or financial products of the entity that are in the same class as the securities or financial products held under the investment strategy does not exceed 30% of the value of the reference index.

Platform Test

If the issuer's PDS states that the interest holder may give instructions to acquire financial products, the PDS lists financial products that can be acquired and the acquisition must be under a custodial arrangement (s1012IA of the Corporations Act). This would apply to certain assets acquired through platforms called wraps, superannuation platforms or IDPSs

If the Platform Test is not met, go to the Asset test and the PDS test.

Assets Test

Under the assets an interposed vehicle includes a body, partnership or trust ('entity') that the issuer believes or has reasonable grounds to believe has more than 70% of its assets by value invested in financial products, other than:

j. financial products that are reasonably regarded as a means by which the entity invests in real property or infrastructure entities; and

k. financial products that confer control of another entity, unless the other entity has more than 70% by value of its assets invested in financial products (excluding the financial products described above and financial products that qualify under this head).

The basis for the real property and infrastructure exception is that property trusts and infrastructure trusts often hold shares or interests in property holding entities without this implying that the holding of interests in the property trust or infrastructure trust is a means of seeking exposure to the underlying assets of the property holding entity, rather than the investment of the superannuation entity or registered scheme in the property trust or infrastructure trust. A property trust or infrastructure trust may be used as an interposed vehicle, but this needs to be considered in light of the investment strategy and other disclosures in the PDS for the product.

The basis for the second is that, generally, a holding that confers control is used to operate a business that is not an investment business, and so does not imply that the entity holding the control is being used as an interposed vehicle. However, if the entity that is controlled is itself an entity that would be an investment vehicle, then the holding should be considered in determining whether the controller is an interposed vehicle.

If the Asset Test is not met, go to the PDS test.

PDS test

An entity will also be an interposed vehicle if, based on the PDS for the product and any other information issued by the issuer, a security or interest in the entity could reasonably be regarded as the means by which the benefit of the investment is obtained, rather than the end investment.

To establish that an entity is not an interposed vehicle, the issuer will need to ensure that a retail client who is given the PDS and any other information would generally clearly understand that what they are acquiring, and therefore what the fees and costs they are charged relate to, is consistent with access to the entity as an end investment rather than a way of securing exposure to assets through the entity.

Derivatives

The definition of indirect costs includes certain derivative costs for over the counter derivatives used for non-hedging purposes (e.g. where derivative are used to gain exposure to a particular asset or meet the investment return objective). Whereas the costs of listed derivatives and derivatives used for hedging purposes (e.g. interest rate swaps for a property fund) would be included as transactional operational costs.

Transactional and operational costs

The definition of management costs specifically excludes transactional and operational costs. Transactional and operational costs are defined to include the following:

a. brokerage;

b. buy sell spread;

c. settlement costs (including custody costs);

d. clearing costs;

e. stamp duty on an investment transaction;

f. costs incurred in or by an interposed vehicle that would be transactional and operational costs if they had been incurred by the scheme.

Details of all transactional and operational costs must be separately stated under 'Additional explanation of fees and costs". ASIC encourages issuers to:

a. include a total of the amounts for management costs and transactional and operational costs as a ratio, calculated on the same basis as an indirect cost ratio is calculated; and

b. illustrate this as a dollar figure by applying it to an example on the same basis as the example of annual fees and costs.

Information about transactional and operational costs is to be determined in relation to the last financial year (except for new products), consistent with the calculation of other costs.

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Issuers should set out how any costs resulting from issues and withdrawals will be borne. If this is recovered in whole or part by a spread between the prices charged to the member for issue of and withdrawal from the product, the issuer should state this with an explanation of how the amount is determined.

ASIC takes the view that amounts that are recoverable from tenants are also required to be included in transactional and operational costs, unless the amount is incurred for the benefit of the tenant. ASIC has not provided any guidance on what amounts incurred for the benefit of tenants means. However, we understand that industry is likely to come up with some guidance in consultation with ASIC.

What you need to do

- Determine whether there are any indirect costs for your funds and particularly whether there are any interposed vehicles.
- Collect management costs information from interposed vehicles.
- Determine the management costs and transactional an operational costs based on the last financial year.
- Consider whether the costs for the last financial year may not be a good indication of costs in the current year and if not include an explanation of this in the additional information for fees and costs.
- **Seek advice, this article is only a summary of some very high level concepts. There are numerous details and nuances in the requirements that also need to be taken into account in completing the fees and costs section of your PDS.**

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