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Revised draft to Treasury's product design and distribution Bill does not address key issues facing retail property funds

Treasury's revised exposure draft to its Treasury Laws Amendment (Design and Distribution Obligations and Product Intervention Power) Bill, released in July 2018, will disappoint many in the unlisted retail property funds industry because it maintains a compliance regime which could see managers shun retail product and favour wholesale.

Property Funds Association believes the draft Bill will severely limit the choice available to retail unlisted property investors, as many unlisted property funds will find it more difficult and expensive to bring retail product to market. The Bill does not apply to wholesale products.

Target Market Determination a key issue

The Bill requires product issuers to undertake a Target Market Determination (TMD), which will be a key source of compliance angst for retail product. The Bill currently provides several requirements for the contents of the TMD without proper guidance on the required form.

PFA understands the importance for product issuers to consider its product's target market. But an appropriate framework and guidance would help promote a common approach. Lack of guidance will only create confusion for consumers and unhelpful complexity.

The TMD will introduce greater challenges for retail unlisted property funds, including:

Unequal cost of implementation:

A smaller product issuer will have a clear differential in costs compared to a larger financial group which has access to financial planning/advice divisions or provides a broad suite of products and services to its customers with an established customer relationship.

Issuers may also have to take extensive precautions with investors, including potential for implementing fact finding and a statement of advice for each prospective investor. This may cause issuers to outsource some aspects of TMD, which potentially introduces other risks.

Operational timeframe issues:

The entire TMD process could place significant operational timeframe pressures on retail product issuers, and could lead to delays. Unlisted property retail fund products often have short capital raising periods for property acquisitions, for settling acquisitions, and for ensuring deposits are not forfeited or further costs incurred.

During capital raising periods many retail clients will be engaged, with whom the product issuer will have no existing relationship. Without detailed guidance or safe harbour provisions, the proposed approach would not provide a practical, efficient or common approach to engaging retail clients.

This would substantially increase risks of an unsuccessful capital raise and potentially limit investment opportunities where retail client applications cannot be processed in time.

Possible incentive to favour larger operators

TMD may not only impact boutique issuers more heavily, they may also act as an incentive for financial advisers and retail clients to invest with larger issuers and institutions, which cover broader asset classes. This may lead to further vertical integration in the financial services industry due to the cost of implementation of compliance measures. This could lead to fewer choices and unsatisfactory outcomes for retail clients, which is counterintuitive to the objectives of the Bill.

Probable incentive to issue wholesale-only product

The increased costs, risks and complexity of raising capital from retail investors will lead to property fund managers considering issuing wholesale funds as the default position for new assets. Availability of unlisted property funds for investment by retail clients could be reduced. This would lead to fewer opportunities for retail investors to diversify their portfolios by including unlisted property, a key asset class in a well-diversified portfolio.

In Conclusion

The PFA argues that ASIC already has substantial tools available to protect unlisted property investors: Chapter 5C of the Corporations Act and ASIC Act applies to managed investment schemes.

PFA also argues that if distributors and issuers of ordinary shares are not subject to the proposed design and distribution obligations, then neither should they apply to units in investment trusts as equivalent financial products. Units in unit trusts are arguably like shares in being well-known to investors and well-regulated.

Legislating a requirement to identify appropriate target markets and distribution channels places more risk on the issuer, and arguably shifts responsibility from the financial adviser to the product issuer.

As the Bill does not apply to wholesale property product, it becomes an easy decision for boutique managers to focus purely wholesale, avoiding additional compliance costs and headaches from retail.

Retail unlisted property funds will need to spend more on compliance, legal advice, and possibly consumer testing than wholesale funds. Not only will this likely result in fewer products available to retail investors, there is potential for greater consolidation among small-to-medium managers.

Retail funds which do go ahead will be under pressure to pass increased compliance costs on to investors.