Property Funds Association

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Tougher regulation and compliance set to impact property funds: what are the most influential regulatory changes?

Property funds must negotiate a stream of new changes to the regulatory environment, and possibly more to come. PFA examines key initiatives likely to have the most impact.

Legal and compliance teams may be feeling a little shell-shocked at the pace and degree of new regulatory change which is coming at them – change which will impact the ways unlisted property funds are developed, structured, managed and sold. It reflects a general shift towards more compliance and regulation, but could potentially be so onerous as to prevent some products from being viable.

Moves towards a more proactive regulator have been building for some time, further encouraged by the current Royal Commission and the understandable reaction to the financial industry's worst traits, exposed.

Chief Commissioner Hayne's interim report, handed down in September 2018, was strong in its language, putting the much-reported financial services misconduct down to "greed" and the "pursuit of short-term profit at the expense of basic standards of honesty".

Hayne asked critical questions of current laws, and suggested the answers may not come from adding newer laws as from simplifying and adequately enforcing the existing laws.

The emphasis on "enforcing" should be noted as just one aspect of the push toward greater compliance which will occupy many financial services firms including property funds. The compliance push has been building for a while, and new rules are being introduced this year which will increase compliance management and costs with some potential to put a brake on new product development.

It's possible more changes could emerge as the Royal Commission concludes in 2019. For now, here are some key items:

ASIC Corporate Plan – 2018/19-2021/22: The recently released ASIC Corporate Plan strongly confirms the shift towards more regulation, more compliance, and tougher penalties. The regulator intends to harden up generally on "white collar" transgressions.

ASIC, in its owns words, has said it wants to be "a more forceful regulator". It is actively looking to "change behaviours", and has received extra government funding to support its aims.

ASIC has signalled new supervisory approaches, which includes placing more supervisory staff on site, and speeding up enforcement outcomes.

Special focus areas include: poor culture and professionalism; incentives which can harm markets; and practices which may target the financially vulnerable. ASIC will look out for misleading communication, unnecessarily complicated product, and conflicts of interest arising from sales-driven incentive cultures

The Corporate Plan includes a proposed upgrade to ASIC's enforcement powers, enhancing the regulator's ability to act, including more power to revoke or cancel a financial services or credit license. The regulator also wants stronger search powers, and stronger penalties.

The corporate plan sets the scene, but several developments will give the regulator more teeth.

Breach reporting: The regulator is seeking to clamp down on breach reporting, after it identified "serious, unacceptable delays in the time taken to identify, report and correct significant breaches of the law among Australia's most important financial institutions".

In its research, ASIC examined breach reporting processes among 12 financial services groups, including the big four banks. These firms were found to have dragged their heels on breach reporting, with ASIC finding an average time of over 4.5 years for the major banks to identify serious breaches.

Significant breaches have caused an estimated $500 million financial loss to consumers. Clearly, and in light of the Royal Commission, this is unacceptable.

ASIC says the institutions are taking too long from starting an investigation to lodging a breach report.

It also identified delays in remediation as a problem. Research found an average of 226 days from the end of an institution's investigation into the breach and the first payment to consumers.

ASIC takes breach reporting seriously and has targeted breach reporting as an area it can make an immediate and obvious impact. While most focus has been on the large institutions, the message is clear – all financial services, including fund managers and property funds, need to be right on top of their breach reporting and ensure they have the processes to investigate, report breaches, and process any remediation quickly.

The big banks may have drawn the spotlight, but property funds can expect consequences for any who are seen to have lax standards.

A big challenge for ASIC is removing previous "ambiguity and subjectivity" in how breaches were identified. These ambiguities were understood to have created inconsistencies and hampered the regulator's efforts to crack down on non-compliance.

Removing these ambiguities requires law reform, which the regulator has recommended, and which has been accepted in-principle by the government. Such reform will make the breach reporting rules more enforceable than previously.

Many will need to invest more in their breach reporting and compliance generally. Property funds will need systems which can locate a breach quickly – by law any breaches must be reported, if they are or are likely to be significant, within just 10 business days. While this has always been the case, there will be less tolerance for those who are not timely in locating and reporting breaches.

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Turbo-charged penalty regime: Treasury has put forward draft legislation to strengthen penalties for corporate and financial sector misconduct. The result will be a significantly tougher penalty regime.

Here is a snapshot:

- Increasing maximum prison terms for certain criminal offences
- Introducing a formula to calculate financial penalties for criminal offences
- Increasing financial penalties for all strict and absolute liability offences

Further, Treasury proposes to introduce ordinary criminal offences which sit alongside strict and absolute liability offences.

They wish to modernise the regime to make a wider range of offences subject to civil penalties – there are also proposals to:

- Significantly increase financial penalties for civil contraventions
- Strip contraveners of their "ill-gotten gains" in civil penalty proceedings
- Harmonise and expand the infringement notice regime

Public submissions have recently closed, but given the current Royal Commission's findings we expect this legislation to be adopted relatively quickly.

AFCA commences: The Australian Financial Complaints Authority (AFCA) commenced November 2018 as a new "one stop shop" external dispute resolution scheme, replacing three existing schemes including the Financial Ombudsman Service (FOS), the Credit and Investments Ombudsman (CIO) and Superannuation Complaints Tribunal (SCT). Former Australian senator, Helen Coonan, will be the inaugural AFCA chair.

All PFA members with retail funds need to be registered for AFCA.

The streamlined complaints handling regime will be freely available to consumers and small business, and hopes to be more efficient than the previous multi-layered approach. But it's also part of a broader push by ASIC to "restore trust and confidence in the financial services industry".

AFCA expects a surge in complaints, fuelled by the Royal Commission. Retail property funds need to pay particular attention to their communications material, including websites and other materials. Communications including complaints brochures need to be updated with the new complaint reporting information.

Product design and distribution guidelines: PFA has previously commented on the proposed product design and distribution guidelines, which will dramatically increase compliance demands for retail property funds.

A major sticking point with this regime is the Target Market Determination, which aims to ensure appropriate products are aimed at the appropriate target markets. It's important a product issuer considers its product's target market, yet crucial an appropriate framework and guidance is provided to promote a common approach: currently, it's possible two product issuers in the same retail product class will have two different approaches to Target Market Determination, due to lack of guidance.

It’s likely the Target Market Determination will add considerably to the compliance burden for new products, including the potential for some level of consumer testing.

PFA believes increased compliance and related expense will likely see boutique retail offerings withdraw from the market, instead targeting the wholesale market where these rules do not apply, resulting in fewer choices for retail property fund investors.

Increased ASIC product intervention powers: The product intervention powers allow ASIC to make prohibitive orders relating to retail financial products. The intended purpose is to reduce the risk of consumers suffering significant detriment from retail products.

What this means in practice for property funds is still ambiguous, as we are still waiting for guidance on what “significant detriment” might mean.

PFA is concerned the product intervention power may unwittingly stifle product innovation – it’s possible some product issuers may regard products as “too risky”, and subject to closure by ASIC, merely because they are novel or present unusual features in the Australian market.

The timelines for these changes may present some further challenges for property funds: the product design and distribution obligations are expected to be implemented within two years after royal assent; while ASICs intervention powers are expected to be implemented immediately.

This could cause problems regarding the redesign and renegotiation of any non-conforming retail financial products with distributors and retail consumers for existing products.

Anything which protects consumers is a good thing. PFA appreciates the need for consumer protection. Finding the appropriate balance is challenging, and PFA hopes consumers can be better protected without negatively impacting the ability for providers to bring new products to market.

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