Five key issues unlisted property funds must know about Treasury's plans on product design and distribution

Key issues for property funds arising from Australian Treasury's Design and Distribution Obligations and Product Intervention Power Proposals Paper

The Australian Treasury's Design and Distribution Obligations and Product Intervention Power Proposals Paper would apply to unlisted retail property funds and could be enacted into legislation during 2018.

Property Funds Association (PFA) believes the proposals could hamper retail investment in unlisted property as the increased compliance obligations could encourage more fund managers to withdraw from retail investment. As the proposals only apply to retail investment, some managers may find it easier to focus on wholesale investors only. This could mean diminished choice for retail investors, less product innovation, and greater consolidation among small-to-medium managers.

What are the key recommendations property funds will be most concerned about?

Firstly, a summary of the key proposals:

Regarding Treasury's proposed design and distribution obligations:

- These obligations would only apply to products designed for retail investors (excluding ordinary shares)
- Personal financial product advisers will be exempt from the obligations placed on distributors
- The obligations apply to both licensed and unlicensed distributors – but the terms are yet to be finalised
- Product issuers will be required to identify appropriate target and non-target markets for their products – this raises several issues which will be explained below
- Product issuers must choose appropriate distribution channels and marketing approaches for the target market
- Product issuers must consider the customers its distribution channels may reach, the risks associated with that distribution channel, the steps to mitigate those risks, and the product's complexity when determining the target market
- Product issuers must periodically review products to ensure both the identified target market and the distribution channel remains appropriate – ASIC must be informed if the review finds a product being sold outside the intended target market
- Product distributors must implement reasonable controls to ensure products are distributed in line with the issuer's expectations
- If legislated, the new obligations will apply to products yet to be released to market six months after royal assent
- If legislated, the new obligations will apply to existing products two-years after royal assent

Regarding ASIC product intervention powers:

- ASIC would have powers to intervene in a product (or product feature), including the types of consumers who can access a product, and the circumstances in which the product is accessed
- ASIC will be required to undertake consultation and consider using alternative powers before an intervention
- ASIC will be required to publish information on the intervention, including the detriment to consumers, and any alternative powers enacted
- ASIC interventions will apply for up to 18 months, with no time extensions available
- ASIC's product intervention powers will apply from the date of royal assent if legislated

Let's consider the five key issues which might impact the unlisted property funds industry:

Key Issue One: All retail financial products except for ordinary shares to be subject to design and distribution obligations and product intervention powers.

Treasury's recommendations apply to all retail financial products except for ordinary shares, placing retail unlisted property funds firmly under these proposals.

The PFA believes there are strong arguments to exclude simple or otherwise well-regulated products from these proposals. We argue that interests in managed investment schemes, particularly units in unit trusts, are similar to shares in being well known to investors and are also well regulated under Chapter 5C of the Corporations Act and ASIC Act. 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.

Placing simple, well-regulated products such as unlisted property funds under this umbrella adds another significant compliance layer on top of that already required under the Corporations Act and ASIC Act, both of which provide considerable powers for ASIC to work with.

The unlisted property sector may find the extra compliance costs involved could slow the release of new retail products to market. This will likely see more opportunities go to wholesale investors at the expense of retail investors.

Key Issue Two: Product issuers must identify appropriate target and non-target markets for their products.

This is a contentious issue due to the compliance obligations involved for retail funds, and the potential to shift more risk onto product issuers.

PFA agrees it's reasonable for product issuers to identify appropriate target and non-target markets for products at a high level.

But the current proposal is very broad. Issuers will need to spend more on compliance and legal advice to ensure they are fulfilling their obligations. For example, more product issuers may need to engage consumer testing before releasing any retail product. This adds a significant cost burden which will likely either: result in more costs passed on to investors; or see more issuers withdraw from the retail market.

This proposal if enacted arguably shifts responsibility from advisors to product issuers.

PFA advocates for high level, principle-based obligations to be legislated, and for the rules around determining target markets to be handled via ASIC guidance. We believe this would provide adequate protections for investors and create a more workable solution for the product issuers, who may consider withdrawing retail product from the market completely if compliance costs rise.

Key Issue Three: Product issuers must periodically review products to ensure appropriate target markets and distribution channels

There could be challenges for unlisted property funds if periodic product reviews operate as blanket obligations involving set review standards and frequencies applied across the board: such a rigid system may not consider the complexity or types of distribution channels which are in place for a particular product.

PFA argues such an obligation should not be required for products no longer offered to investors, including funds which have launched but are no longer open to investment.

Product issuers will also be looking for some assurance that any review is to ensure a product remains appropriate for a distribution channel, and does not seek to impose a higher standard.

Key Issue Four: Obligations for new products may commence six months after being legislated

The proposal recommends the product design and distribution obligations apply to new products just six months following royal assent. This short time frame will create many challenges for product issuers.

Both issuers and distributors will need to update their systems and processes to meet the new obligations – in unlisted property, the timeframes from product conception to market can be significant, which also means many products in the development pipeline may be negatively impacted. PFA feels a longer timeframe, at least 12 months, would be more appropriate for issuers and distributors.

The proposals allow more breathing space for existing products: obligations would not apply for two-years, which is reasonable. (PFA believes legacy products should be exempt as they are no longer being distributed.)

Key Issue Five: Product intervention powers

The proposed product intervention powers would give more powers to ASIC, including more capacity to intervene in the early stages of product development. There are times when early intervention may be beneficial, but there is also potential for early intervention to stifle innovation and create uncertainty.

ASIC already has an extensive regulatory toolkit and shown an increasing willingness to be more proactive. ASIC also has significant enforcement powers under the Corporations Act and ASIC Act, including influence over financial services licensing. ASIC may issue a stop order (following a hearing) where a Product Disclosure Statement is defective or is not clear, concise and effective. ASIC may also issue an interim stop order without consulting the issuer where it considers a delay would be prejudicial to the public interest. The issue of stop orders can have significant consequences for an issuer and as such ASIC may have significant influence on disclosures made by an issuer facing a stop order.

A major potential sticking point with ASIC's new intervention powers is the proposal for interventions to apply for an initial 18-month period, without possibility for extensions. If property products are held up for 18 months due to intervention it could be difficult for them to re-enter the market. In its submission to Treasury, PFA proposed limiting interventions to no more than 12-months.

ASIC will be required to undertake consultation and to also consider using alternative powers before making an intervention. PFA agrees with Treasury's proposal for ASIC to consider consultation and alternative powers before intervention, provided the consultation occurs within a reasonable timeframe.

ENDS