Property Funds Association

June 2018

Lessons for property funds from the Royal Commission

Six critical themes for the property investment funds industry emerging from the current Royal Commission.

The current Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry has not focussed directly on property investments as yet, but several themes raised during the commission will impact the property investment funds industry.

The over-riding theme is the new regulatory environment which is unfolding. While compliance and regulation has become tougher in recent times, reporting from the Royal Commission suggests we can expect regulations to become tougher still.

The regulator, the Australian Securities and Investment Commission (ASIC), has been scrutinised and subject to profound criticism during the Royal Commission – reports have variously described ASIC as "missing in action", "gun-shy" and a "toothless tiger" while accusing the regulator of failing to act against the major banks. We can expect to see a more active and powerful regulator.

Steps to strengthen the regulator's role were underway before the Royal Commission, and have only been enhanced by the Commission's findings to date. Consider the ASIC Enforcement Review, the proposed product design and distribution obligations, and the proposed ASIC product intervention reforms. These proposals form an important backdrop to the commission.

All recommendations from the ASIC Enforcement Review were recently accepted, or accepted in-principle, by the Government. These recommendations will increase compliance obligations for property funds, and include new rules around breach reporting, higher penalties for breaches, greater controls around licensing, and reflect a regulator determined to become more proactive.

Other proposed reforms, including ASIC's product design and distribution obligations, and an increase in ASIC's intervention powers, have been accepted by the Government – these proposals could be enacted into legislation this year, with the product design and distribution obligations in particular likely to increase compliance obligations and costs for retail property funds.

Six critical issues:

All property funds can expect more stringent regulations, and therefore need to prioritise compliance and review all their systems. Six critical issues which have been highlighted by the Royal Commission include:

Remuneration arrangements with advisers and intermediaries: All investment managers need to review their remuneration arrangements with advisers and intermediaries in the context of FOFA. Grandfathering arrangements have been put under the spotlight with potential for change, and all managers will need to be across the sometimes complex grandfathering arrangements they may have with dealer groups and independent financial advisors.

Breach reporting: Many financial services providers have taken too long to identify and report compliance breaches. In some ways this has reflected ambiguities in the law, which has let industry take a more liberal view on when obligations to report arise and how they are tested – for example, financial services firms commonly used tests which could be considered "subjective" in nature. They will now be better off complying with a more stringent and objective test. This issue in breach reporting was flagged in the ASIC Enforcement Review (which has been accepted by the Government) before the Royal Commission was considered.

Property funds must now review their existing processes to ensure their breach reporting processes involve sufficient objectivity, and can identify breaches early. Good governance and compliance demands that appropriate steps are in place and implemented, and ready for any new obligations on the way. Reviewing these steps will help property funds prepare for a stricter regime and the likely introduction of ASIC's product design and distribution obligations

Monitoring and supervising product representatives and distributors: The Royal Commission has made it clear all product representatives and distributors must act ethically and in the client's best interest. Most importantly, an emerging theme is that fund managers may no longer plead ignorance regarding behaviours from their product representatives and distributors. Rather, they may be required to have appropriate steps in place to ensure compliance.

Independence of legal reports: This was an issue flagged in the Royal Commission following an example of a legal report provided to AMP, which claimed to be "independent" yet the law firm is said to have provided 25 drafts of their report to AMP. The key lesson is being careful using words which suggest "independence" in reports, as any independent report needs to stand up to scrutiny and be consistent with objective evidence. Financial services providers need to ensure they do not unduly influence a report, and may need steps in place to ensure independence.

Vertically integrated models: The vertically integrated model in financial services has come under more scrutiny during the Royal Commission. Banks with vertically integrated wealth management entities will most likely either spin off or sell their advice business, or set them up with independent governance structures including an independent board. Breaking up vertically integrated models may have a silver lining for property funds as the bigger financial services firms may potentially consider a broader product range.

New reporting for non-bank lenders: This has not been a big talking point at the Royal Commission but fits with the broad push toward tighter regulations. A recent amendment to the *Treasury Laws Amendment (Banking Measures No.1) Act 2018* (Amendment) extends the Act's registration requirements with APRA to more "non-authorised deposit taking institutions" by imposing more limited exemptions from registration.

Any corporation involved in providing finance will now be required to register if: it has outstanding debts due to providing finance, which are at least $50 million; or in the previous financial year it made loans (or other financing arrangements) under which it provided $50 million. An important note: APRA will treat each related corporation as part of the relevant lender corporation when determining whether the amount owing to the lender corporation exceeds $50 million.

Lenders falling into this category will need to register with APRA and prepare for a more active reporting and compliance regime.