



# Submission to the Financial System Inquiry

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26 August 2014

**Dear Panel Members**

**Property Funds Association of Australia - Second Submission to the Financial System Inquiry**

We welcome this opportunity to make a second submission to the Financial System Inquiry (**Inquiry**) following our first submission on 31 March 2014. For ease of reference we have shown our changes to our first submission as highlighted text in this second submission.

**BACKGROUND**

The Inquiry commenced with the release of Terms of Reference which were finalised on 20 December 2013.

Submissions for a first round of consultations, based on the Terms of Reference, opened on 30 January 2014 and closed on 31 March 2014. As part of this process, the Inquiry received over 280 submissions, including a submission from the PFA.

An Interim Report was issued on 15 July 2004 and called for a second round of submissions to be made by the date of this submission.

The Interim Report makes numerous observations and raises policy options relating to key themes and issues. These key themes are growth and consolidation, post-GFC regulatory response and emerging trends such as international integration. They are inextricably linked and must be balanced and harnessed to underpin a healthy financial system.

Our second submission picks up on how the key issues identified in our first submission have been addressed (or otherwise) in the Interim Report.

The effective treatment of these key issues is vital to the ongoing operation and growth of the unlisted property funds sector in Australia which is an important part of the financial system as a whole.

I would once again like to acknowledge the Issues and Regulatory Committee and Hall & Wilcox for preparing this submission on behalf of the PFA.

We would be pleased to continue to assist the inquiry and be involved in any further consultation in relation to these matters and other proposed reforms which may impact the unlisted property funds sector.

Yours sincerely

A handwritten signature in black ink, appearing to read 'Paul Healy', with a large, sweeping flourish at the end.

Paul Healy  
Chief Executive Officer  
Property Funds Association of Australia

## EXECUTIVE SUMMARY

The PFA makes the following submissions to improve the liquidity of the unlisted property funds sector and to enhance the competitiveness of the sector.

1. Secondary market to facilitate transfer of interests in unlisted property funds.
2. Extension of the ASX mFunds platform.
3. Allowing property funds to issue shorter product disclosure statements (**PDSs**).
4. Ability to acquire small parcels.
5. Relief from unsolicited offer provisions.
6. Reform provisions relating to winding up of insolvent funds.
7. Review of compliance regime.
8. Harmonising stamp duty rules.
9. Acceleration of Asian Region Fund Passport program.
10. Review of MIT withholding rates.
11. Recognition of overseas regulatory regime for fund managers.

## **A. Liquidity and access to investment in unlisted property funds**

The illiquid nature of the underlying assets of property funds combined with the lack of a secondary market for property funds has presented problems for the unlisted property funds industry and investors in unlisted property funds.

In certain situations, investors may wish to redeem their interests in the fund. Whilst investors are informed of the illiquid nature of their investments, the introduction of certain mechanisms can assist in allowing investors to exit their investment.

### **1 Secondary market to facilitate transfer of units (Clearing House)**

Although an investment in unlisted property funds is generally a long term investment, an investor's personal circumstances may mean that they need to liquidate their investment from time to time.

As unlisted property funds are generally 'illiquid' for the purposes of the withdrawal provisions under the Corporations Act, fund managers are often unable to offer individual investors the opportunity to exit the fund.

However, fund managers may be aware of potential investors who wish to acquire units in the fund. In such situations, the fund manager may wish to connect the potential purchaser with potential sellers of units in the fund and facilitate the transfer of units. However, the licensing and regulatory framework may prevent the fund manager from matching buyers and sellers of units. Under the Corporations Act, fund managers are prohibited from operating a financial market for the trading of unlisted securities. The restriction prevents the fund manager from bringing together sellers and buyers and facilitating a limited secondary market for units in unlisted property funds.

The obligations on fund managers as financial service licensees to act efficiently, honestly and fairly provide an appropriate basis for regulatory oversight of such a clearing house for units in unlisted property funds or other investment funds.

#### **First Submission**

Amend the Corporations Act so that fund managers are able to connect willing buyers and sellers to facilitate the transfer of units.

#### **Interim Report**

The FSI does not appear to comment specifically on this issue.

#### **Second Submission**

The PFA confirms its First Submission.

## **2 ASX mFunds Settlement Service**

The PFA welcomes the introduction of the mFunds platform by the ASX and believes the concept should be extended to the creation of a trading platform for interests in unlisted property funds.

The mFunds platform provides investors with the ability to apply for and redeem units in managed funds through their stockbroker or adviser through electronic means without the need for paper based applications. Trades are effected through the ASX settlement system and in accordance with the ASX's operating rules which provides investors with additional confidence in respect of the settlement process. Holding balances can also be linked to the investor's Holder Identification Number alongside the investor's holdings in other investments transacted through the ASX.

The ASX has also indicated that the mFunds platform will contain aggregated information on participating fund managers, including information regarding the level of management fees, distributions, copies of the PDSs and details on the fund managers. Market announcements made by the fund managers will also be made available on the mFunds platform.

The development of the mFunds platform represents the ways in which technology is able to provide more efficient ways to disseminate information to investors. Investors are able to obtain information regarding managed funds and the fund managers from a central source and more readily compare such information.

However, the mFunds platform is only available to simple managed investment schemes that are able to issue a short form PDS. This excludes the significant offering of unlisted property funds to investors.

There is no policy basis for preventing investors in unlisted property funds from accessing the benefits of the mFunds platform. Property as an asset class does not necessarily entail additional risk compared to other assets which will be available on the mFunds platform. Furthermore, the exclusion of property funds on the mFunds platform reduces the competitiveness of unlisted property funds compared to their listed counterparts. The exclusion of unlisted property funds may also reduce the attractiveness of an investment in unlisted property funds, thereby skewing investment away from property to other asset classes and reducing domestic ownership of property in Australia.

### **First Submission**

Allow unlisted property funds to be admitted to the mFunds platform.

### **Interim Report**

The FSI does not appear to specifically comment on this issue.

### **Second Submission**

The PFA confirms its First Submission.

The report refers to information asymmetries in a number of instances. A solution which addresses both information asymmetries and facilitation of unit transfer is required. A market place which is less comprehensive than an ASX listing may be a solution.

Allowing interests in unlisted property funds to settle on the mFunds platform should simplify the settlement process reducing costs and increasing effectiveness thereby raising the mFunds profile and trading volumes on the secondary market for interests in unlisted property funds.

### **3 Extend shorter PDS regime to property funds**

PDSs are generally lengthy documents. Much of the information contained in PDSs are standard provisions which are required by the Corporations Act. There may be more concise and succinct ways to present relevant information to investors.

Currently, certain types of managed investment schemes are allowed to issue short PDSs to investors. The shorter PDS regime stipulates the maximum length for PDSs and aims to ensure that only relevant key information is presented. Additional information may be contained in a supplementary document which is incorporated by reference.

Property funds are not currently subject to the shorter PDS regime. This increases the cost for fund managers when seeking to undertake a capital raising or launch a new fund. Furthermore, the disclosure provided may not be sufficiently targeted for investors to understand the key information regarding their investment.

Additionally, allowing property funds to issue shorter PDSs will mean that property funds will be eligible to be included on the mFunds platform.

#### **Submission**

Extend the shorter PDS regime to property funds.

#### **Interim Report (see 3-58)**

The report notes that the current disclosure regime produces complex and lengthy documents that often do not enhance consumer understanding of financial products and services, and impose significant costs on industry participants.

It was for these reasons that the new shorter PDS regime was enacted. However, the report notes that some submissions argued that the new shorter PDS regime which is available for simple managed investment schemes has not resulted in significant consumer benefits to date.

Despite this, the Inquiry is seeking submissions on the suggestion that disclosure should be seen as part of a more flexible framework to inform consumers in their financial decision making.

#### **Second Submission**

The PFA accepts that the issue of effective disclosure to consumers is complex and that the current disclosure challenges are a function of disengagement, financial literacy, complexity of products, consumer behaviour and structural issues. Disclosure is only one piece of the puzzle. However, the

PFA believes that consumers are more generally aware and familiar with direct property as an asset class. In this context, the way in which product features are communicated is important. Regulatory developments that have targeted disclosure such as ASIC Regulatory Guide 46 *Unlisted property schemes - improving disclosure for retail investors* have been welcomed by industry and enhanced consumer understanding of unlisted property funds. However, the PFA believes that extending the short PDS regime to direct property will further enhance consumer decision making and comparability as well as distinguishing between simple and more complex direct property offerings. In particular, a targeted short form PDS regime may better assist investors to understand the nature of property funds and the associated investment risks by enabling:

- a more clear, concise and effective description
- a better appreciation of the key features (including risks and returns) of the product, and
- improved ability to assess and compare fund performance on an ongoing basis.

#### **4 Small parcels**

Unlisted property funds may often have unitholders on the register who only hold a small parcel of shares. These smaller unitholders impose a disproportionate administrative burden on the fund relative to the size of their investment, which must be borne by all unitholders equally.

Issuers of interests in listed funds on the ASX may utilise the small parcels mechanism to acquire small parcels held by these investors in the same manner as issuers of listed shares. ASIC has also previously issued relief that this mechanism is available for unlisted securities.

The same relief should be extended to unlisted property funds. The relief should indicate that the issuer will be deemed to have complied with its duties to treat all unitholders equally in undertaking a minimum parcel buyback.

#### **Submission**

Extension of relief for sale of small parcels to reduce compliance burden for fund managers.

#### **Interim Report**

The report does not appear to specifically comment on this issue.

#### **Second Submission**

The PFA confirms its First Submission.

## **5 Unsolicited offers**

The unsolicited offer provisions in Pt 7.9 of the Corporations Act are intended to protect unsuspecting unitholders from buyers offering to purchase their units at a discount. However, the provision is drafted extremely broadly and covers various instances where the fund manager or the responsible entity itself is intending to buyback its own units as part of a liquidity offer to unitholders.

Fund managers or the responsible entity generally need to apply to ASIC for relief from these provisions when conducting a liquidity offer. The relief is of a standard nature and is generally granted. This imposes an additional layer of regulatory approval and burden which needs to be met which adds to the costs, time and resources of providing liquidity to unitholders.

Where the person making such an offer is the issuer of the products at net asset value or higher, the unsolicited offer provisions should not apply. We note that the related party and conflict management provisions under the Corporations Act, as well as provisions in constituent documents would still apply to safeguard the interest of investors.

### **Submission**

Exclude the operation of the unsolicited offer provisions when the offeror is the issuer of the products.

### **Interim Report**

The report does not appear to comment specifically on this issue.

### **Second Submission**

The PFA confirms its First Submission.

## **B. Competitiveness of sector**

### **6 Amending winding up regime for insolvent schemes**

Solvent schemes operated by responsible entities which may be insolvent face difficulty in attempts to restructure the scheme.

In contract based schemes, the rights of creditors and other third parties in relation to the scheme may be unclear, which may deter other responsible entities from assuming the operation of the scheme. This may lead to schemes which are viable being wound up and affect the efficient allocation of resources.

#### **Submission**

Develop a clearer winding up regime for schemes which is similar to that of the regime for companies.

#### **Interim Report**

The report does not specifically comment on this issue.

#### **Second Submission**

The PFA confirms its First Submission.

We note that this is a recommendation in the Corporations and Markets Advisory Committee (CAMAC) in its report titled CAMAC 2014, Managed investment schemes, CAMAC 19 June 2014.

## **7 Review of efficiency of compliance requirements**

The development of the compliance culture for schemes has imposed a large volume of obligations on responsible entities.

These obligations should be reviewed to determine whether they are efficient in ensuring responsible entities meet their obligations, or whether it has imposed additional costs for responsible entities in hiring compliance professionals without delivering benefits for investors.

### **Submission**

Review of compliance obligations imposed on managers of unlisted property funds to determine whether compliance measures result in additional protection and whether a more risk based and less prescribed regime may be more appropriate.

### **Interim Report**

The report does not appear to comment specifically on this issue.

### **Second Submission**

The PFA confirms its First Submission.

Consistent with the theme of international integration a review of current compliance obligations and their consistency with international regulation and compliance should also be undertaken. For example, the recent IGA in relation to FATCA was, in part, required due to potential inconsistency with Australian rules and regulations.

## **8 Stamp duty rules**

Any change in the trustee of the fund will necessitate an examination of applicable state stamp duty legislation as the change will need to be assessed by a duty officer and may trigger stamp duty. Certain property funds may have property located in all jurisdictions. The various stamp duty regulations which vary between the states result in an arduous process for fund managers. The Inquiry presents a great opportunity to examine the stamp duty laws in each state and territory with a view to harmonising the regulations and the manner in which the regulations are applied.

Each state revenue office also appears to adopt different approaches when examining duty assessments. This adds unnecessary red tape and costs for fund managers in taking over property funds.

### **Submission**

COAG should review the stamp duty laws in each state and territory in order to harmonise the rules across each state and territory.

### **Interim Report**

The report does not appear to comment specifically on this issue.

### **Second Submission**

The PFA confirms its First Submission.

Note that other indirect taxes, in particular, the GST treatment of financial supplies, for example, the operation of section 184 of the GST Act, in the context of the bundling of fees, should also be reviewed.

### **C. International competitiveness**

Australian fund managers have extensive experience in managing significant property for the benefit of investors.

Australia's sophisticated and stable regulatory framework for managing unlisted funds provides an attractive investment proposition for many overseas investors. Additionally, many overseas investors are interested in investing in the property sector in Australia, given the stable regulatory regime and legal system. However, there are certain areas, where regulatory amendments may be desirable to improve the competitiveness of Australia as a financial services hub for inbound investment.

## **9 Asian Region Fund Passport**

Currently, there are various restrictions in offering and marketing products to investors outside of Australia. The Asian Region Fund Passport will allow fund managers to offer their products efficiently, conveniently and easily to jurisdictions outside of Australia. This will increase the ability of Australian fund managers to attract additional capital for investment and increase economic growth in Australia.

### **Submission**

Accordingly, the implementation of the Asian Region Fund Passport should be accelerated. Furthermore, property should be included as an asset class to the Asian Region Fund Passport.

### **Interim Report (see page 4-97)**

The Passport is a mutual recognition agreement for managed investment schemes. It will allow a fund registered in its home economy to be offered in other participating countries, without different operational and licensing requirements.

### **Second Submission**

The PFA welcomes the report's recognition of the development of the Asian Region Fund Passport as a mutual recognition agreement which will foster international competitiveness.

Please note expanding the scope of clearing houses, the mFunds platform and the short form PDS regime to include property funds will form the basis of a coherent and consistent approach to attracting greater levels of offshore sources of capital for unlisted property funds.

## **10 Reduction of MIT withholding rates**

The withholding rate for managed investment trusts, as well as the complex definition of a qualifying managed investment trust may deter investors from pursuing an investment in an Australian managed fund. Australia's MIT withholding tax rate of 15% is significantly higher than the similar rates in Hong Kong and Singapore.

This places Australia at a significant disadvantage when investors are choosing their preferred investment jurisdiction.

### **Submission**

The MIT withholding tax rate should be reduced from 15% to 10%.

### **Interim Report**

The report does not appear to specifically comment on this issue.

### **Second Submission**

The PFA confirms its First Submission. The PFA also notes that the MIT withholding rates should be reviewed in conjunction with the current interest withholding and thin capitalisation rules.

## **11 Recognition of overseas regulatory regime for fund managers**

The Asia Pacific region is becoming an increasingly important source of capital for funds operating in Australia. The enthusiasm for the SIV regime in Australia reflects the appetite for the inflow of capital to support the growth of the property funds sector.

However, the regulatory regimes for offering interests in property funds to other jurisdictions prevent Australian fund managers from accessing this pool of capital. Fund managers will generally need to prepare specific disclosure documents to meet the requirements of each jurisdiction in which they wish to offer interests. The compliance costs for doing so is generally prohibitive. Currently, there is only a mutual recognition scheme between Australia and New Zealand.

Additionally, overseas fund managers who may have the requisite fund experience will still need to undergo extensive application processes to obtain a licence to operate a fund in Australia. The overseas fund managers may have access to a distribution network and be able to source capital for their Australian based funds.

### **First Submission**

Develop a framework for mutual recognition of disclosure documents in other jurisdictions which comply with Australian disclosure document requirements.

### **Interim Report (see 4-97)**

The report notes that it received a number of submissions that suggest reducing barriers to offering managed investment scheme products internationally to attract interest in Australian managed funds. Industry submissions indicated major impediments include the unique structure of Australian managed investments schemes and the uniqueness of Australian regulation of collective investments.

The Inquiry would value views on the costs, benefits and trade-offs of improving domestic regulatory processes to better consider international standards and foreign regulation.

### **Second Submission**

The PFA believes that Australia has the regulatory tools in place to assess and change impediments to the Australian MIS structure. ASICs approach to financial services licensing exemptions for foreign financial services providers recognised jurisdictions and market regulation is an example of effective substituted disclosure. Both increasing mutual recognition and increasing recognition by Australia of financial institutions regulated by overseas regulatory authorities should be encouraged to facilitate cross-border access to financial products. Such facilitative cross border regulatory settings should assist Australia's integration in to the broader international financial system.

Moreover, the increasing prevalence of UCITS funds across Asia is a partial proxy for the potential for increased recognition of another common regulatory framework within Asia.

The PFA submits that there are many recommendations made by the Corporations and Markets Advisory Committee (CAMAC) in its report titled CAMAC 2014, Managed investment schemes, CAMAC 19 June 2014 which should be taken up by the government to improve the operation of MIS in Australia and also enhance the attractiveness of Australian MIS regulation to overseas markets.

The Asian Regional Passport Fund project should be used to drive such change within the existing regulatory framework. As discussed above, the PFA believes that this initiative should be extended to unlisted direct property funds.