ASIC and the property sector

A presentation to

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by

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Introduction

Good morning everyone and thank you for inviting me to speak here today.

My topic for today is ASIC and the property sector. This is an interesting topic in itself, given that ASIC's jurisdiction in relation to property is limited.

Therefore, my presentation this morning will be divided into three sections.

First, I would like to talk about ASIC's role in regulating listed property trusts, focussing in particular on the Product Disclosure Statement.

Second, I would also like to discuss the regulation of *direct* investment in property. Concerns about investment seminar operators and property spruikers, and the collapse of Henry Kaye and the National Investment Institute's operations, have focussed attention on the framework for regulating advice about, and promotion of, direct investment in real estate. The question has been asked whether there is a need for law reform in this area. I would be interested in hearing what you—as representatives of the sector that issues managed investments in property—have to say on this theme.

Finally, I would be interested to hear of your concerns in relation to regulation of property, and in particular investment advice so far as it is relevant to property, across the board.

Property trusts and disclosure

Regulation of listed property trusts: overview

Let me start with some general comments about ASIC's role in regulating listed property trusts.

It is fair to say that ASIC undertakes less surveillance on listed property trusts that on other managed investment schemes. There are two main reasons for this. First, the product is reasonably simple and can be described relatively easily by issuers. And, secondly, as you are aware, the product is regulated primarily by the ASX once the securities have been listed.

During the FSR transition period, ASIC indicated some concerns about the contents of Product Disclosure Statements being issued by property trust issuers.[1] Areas identified were:

- Use of theoretical returns and unsupported forward-looking statements
- Failure to explain the risks and the use of only positive gearing examples.

[1] Media Release 03-052 (13 February 2003)

- Failure to explain financing arrangements and limited recourse loans
- Failure to include the Net Tangible Asset backing per unit, and
- Failure to explain, as a significant feature of the product, the possible dilution of investors' interests by future transactions.

The problems we identified have been, at least in part, transitional ones. As you know, the FSR product disclosure regime requires the product issuer to make *judgments* about the level of disclosure required in relation to the key areas of significant risks, features and benefits of a product. With time and greater experience of the regime, those judgement calls have been—and we hope will continue to be—refined.

Going forward, we would expect, as with other product areas, to need to intervene less frequently than in the past to ensure that property trust product disclosure meets the required standards.

I would emphasise, however, that ASIC will use its stop order powers where we see potential consumer detriment and blatant non-compliance with the new disclosure regime.

With this in mind, I'd like to outline our approach to disclosure requirements applicable to all financial products, and then discuss some specific issues that arise in relation to property trusts.

PDS disclosure: general issues

Fees and charges

ASIC has taken corrective disclosure action where disclosure of fees and charges in the PDS is deficient—where, for instance, there is little or no disclosure of:

- the percentage or dollar amount of fees
- the way they are calculated, or
- how and when a fee or charge is paid.

Nor will we accept a situation where there is inadequate disclosure of a product issuer's capacity to vary fees and charges, including references to maximum permissible fees.

In general, a PDS that includes only broad descriptions of costs, with no indication of the factors affecting the amount of those costs, will not be acceptable.

Information about the risks related to acquisition of a financial product

ASIC is mindful that the level of significant risk may differ between classes of financial products, and within those financial product classes themselves.

For complex products that are not well understood, even where a particular risk is judged not to be significant, the *presence* of that risk should be disclosed. The presence of a particular risk could be a significant feature of the product; and significant features need to be disclosed to enable the retail investor to understand how the product works.

For other investment products, ASIC has investigated such areas as:

- whether product-issuer risk is disclosed, where appropriate
- whether investment strategy information is complete and adequate, and
- whether the liquidity of the investment, including the capacity to redeem the investment, is fully disclosed.

Past performance

ASIC also considers whether statements about past performance are misleading or deceptive. Among other matters, we are concerned that the issuer's advertising and PDS avoid stating or implying a link between past performance and future prospects, and that it contain effective warnings about the limited significance of past performance information.

Statements based on hypothetical or reconstructed past performance figures are very likely to be misleading or deceptive, and we have taken action in relation to such statements on a number of occasions.

Representations about future financial performance

ASIC considers all representations made about future financial performance in the context of whether there are reasonable grounds for those representations.

Material assumptions on which future representations are made must be adequately disclosed. So must:

- the expected time period for the expected returns to be realised;
- the risks that they will not be realised, or not realised within the expected time frame; and
- the method by which the prospective information was calculated.

Investors must also be warned about the limited reliability of prospective financial information.

Issues relating to the presentation of information in a PDS

This is the final general aspect of PDS disclosure that I want to mention. How, mandated information is presented in a PDS is something that, again as you will be aware, ASIC has been focussing on recently.

The *Corporations Act* requires that information in a PDS be presented in a *clear, concise and effective manner*[2]. I'd emphasise that statutory phrase—clear, concise and effective. As far as ASIC is concerned, this means, among other things that:

- key information about risks should be presented as prominently as information about benefits

[2] Section 1013C(3), Corporations Act 2001

- key consumer information—contact details, cooling-off rights, the issuer's external dispute resolution scheme—should be prominently and clearly stated
- jargon should be avoided, as far as possible, and terms should be defined within the document, and
- additional information where provided should be readily accessible and appropriately referenced.

PDS disclosure: Specific issues for property trusts

As you will be aware, apart from our general policies on product disclosure, ASIC has also developed policies and guidelines specifically for property trust issuers. Some of these are of a quite technical nature. So I will simply list the main areas covered in our policies and guidance, and then discuss a few of these areas in a little more detail.

The areas covered include:

- identification of trust property[3]
- the use of internal rates of return
- the use of average annual return rates[4]
- disclosure about valuations
- net tangible asset backing[5]
- distribution from capital[6]
- acquisition costs[7]
- income support receipts[8]
- depreciation of plant and equipment (if material)[9]
- anticipated repair and maintenance (if material)[10]
- taxation considerations
- identification of the term[11]
- general warnings[12]

To take a couple of the key areas:

The valuation summary

In the property trust context, the valuation summary is clearly central to effective and informed decision-making by investors. The PDS should generally disclose information on the following:

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[3] ASIC Policy Statement PS 77.73
[4] ASIC Media Release 00/85
[5] ASIC Practice Note PN 64.17
[6] ASIC PN 64.12 and PN 64.13
[7] ASIC PN 64.26, PN 64.24 and 64.25
[8] ASIC PN 64.36
[9] ASIC PN 64.37
[10] ASIC PN 64.38
[11] ASIC Policy Statement 77.70
[12] ASIC PS 77.80

- the valuation methodology, and associated details depending on the valuation method used
- the material assumptions—about rental growth, occupancy levels and other matters—underlying the valuation
- details of market supply and demand for similar properties
- whether the valuation is consistent with comparable sales (if applicable)
- details of any special factors that have been taken into account in the valuation—for example, if the vendor has provided a rental support or guarantee to the Responsible Entity for a period
- if the property is a development property, the basis for the stated valuation. Note that we regard valuations on an "on completion" basis as generally unacceptable, and
- the qualifications and experience of valuer. Any potential conflicts of interest that the valuer may have must also be disclosed.

Internal Rate of Return

ASIC considers that an internal rate of return [IRR] should generally not be quoted. The IRR involves an estimate of the net proceeds of the sale of the property at the end of the scheme life. As it is generally difficult to predict the state of the property market many years into the future, any estimate is likely to be without a reasonable basis, and should not therefore be quoted.

On the other hand, if there is a forward contract to sell the property or there is a positive assurance opinion from an expert on the sale price, quoting an IRRs may be acceptable.

Quoting the Average Annual Return (AAR)13

As you are aware, the Average Annual Return is a simple average of the forecast annual rates of return over the forecast period. It does not take into account the time value of money and, in many contexts—for example, agricultural schemes—it is likely to be misleading.

As property schemes tend to have fairly steady returns from year to year, the time value of money distortion is less dramatic. In consequence, disclosure of the AAR may be acceptable in the property trust context. However, the following requirements need to be observed:[14]

- The AAR should not given undue prominence. For example, it should not be on front cover of the PDS or highlighted.
- The AAR should only appear on the same page as the table of annual returns over the forecast period. This is so that investors can readily see that the AAR may not be achieved in the early years.
- An explanation of how the AAR is calculated should be included, and it should be noted that the AAR does not take into account the time value of money.

[13] ASIC Media Release 00/85
[14] Media Release 03-052 (13 February 2003)

In addition, an AAR should *not* be used as a headline rate in advertising.

Net Tangible Asset backing15

The PDS should disclose the net tangible asset backing per unit on completion of fundraising. This is so that investors are made aware of the impact of issue costs on the value of their units.

Taxation considerations

If the PDS represents that there are material tax advantages associated with investing in the trust—for example, depreciation, amortisation or other allowances—these representations should be supported by statements from experts, or directors who are suitably qualified to comment on taxation issues. It distributions are described as "tax advantaged" or "tax deferred", these terms should be explained.

Regulation of property investment seminar operators and promoters

I want to turn now to the second part of my talk, and make some observations on the property investment seminar operators and promoters.

As you will be well aware, there has been a marked increase in the level of direct investment in rental properties by retail investors in recent years. By far the larger portion of this investment has been in the residential housing market, rather than in commercial property investment.

According to the Productivity Commission's *First Home Ownership: Discussion Draft* (December 2003), the proportion of households with an investment property has grown from 8 to 12 per cent over the past decade.

It would appear that, even excluding owner occupiers, the average Australian investor has more money tied up in directly held real estate investments than in directly held sharemarket investments.

There are clearly a number of reasons for the increase in direct property investment by retail investors in recent years, including:

- expectations of rising house prices and, with this, the desire of investors for capital gain
- cheaper and easier access to housing finance; and
- the taxation treatment of real estate investments

Another factor behind the growth in direct investment in real estate would appear to be what the Productivity Commission has called the "aggressive marketing of housing investment 'opportunities'". This phenomenon has also been commented on, on a number of occasions, by the Governor of the Reserve Bank.

[15] ASIC Practice Note PN 64.17

Let me make some observations relevant to this phenomenon myself.

Like the Reserve Bank and the Productivity Commission, ASIC also has concerns about the marketing of investment training services and investment properties to retail clients by seminar operators and others associated with the property industry.

On the basis of the complaints we receive, and our own surveillance activities, we consider that there have been, and continue to be, significant consumer protection and marketplace problems associated with property investment advice and promotion.

These include problems in relation to the quality of advice and/or competency of advisers. For instance, we are concerned that high-risk strategies (for instance, use of deposit bonds to allow the investor to purchase multiple off-the-plan units which they hope to sell on a rising market prior to settlement) have been, and continue to be, promoted without sufficient—or in some cases any—attention being paid to the downside risks associated with those strategies.

We are also concerned about the non-disclosure of commissions and other benefits, and associations and relationships, by promoters of direct investment in property. Many of these marketers would appear to present themselves as disinterested or objective advisers or 'wealth creation' educators when, in reality, they are effectively sales representatives for developments in which they have an interest, or through promotion of which they derive undisclosed commission payments and other benefits.

Other areas of concern include:

- the inflated claims about potential returns—and the certainty of those returns— made in advertising and promotional seminars
- the inability of consumers and investors to obtain 'guaranteed' refunds if the consumer is not satisfied with a property investment training course
- the very high fees charged to retail investors for some of these courses, and
- the widespread use of manipulative and high-pressure selling strategies generally.

Now, where property spruikers promote financial products—for instance, property investments structured as managed investments—their activities will come within the Chapter 7, *Corporations Act* regulatory regime for financial services and, with this, ASIC's regulatory scrutiny.

On the other hand, as you will be aware, advisory and other activities in relation to *direct* investment in property, and associated financing arrangements, are generally not caught by the financial services laws. As such, apart from the general law, they are only subject to the general *Trade Practices Act* prohibitions of unconscionable conduct, misleading and deceptive conduct, false and misleading representations, and so on.

In other words, in contrast to those who distribute *your* products, for instance, and other financial products, people who confine themselves to advising on and promoting direct investment in property are not required:

- to meet training and competency requirements
- to disclose their conflicts of interests to those they advise
- to belong to, or be an Authorised Representative of a licensee that belongs to, an approved external dispute resolution scheme; or
- to meet the many other requirements of the Australian Financial Services licensing regime and the other requirements of Chapter 7 of the *Corporations Act*.

On the face of it, this may appear somewhat anomalous, given the clear functional similarities between giving investment advice about property and giving advice about financial products such as shares, managed investments, bonds etcetera.

Certainly, from a consumer protection perspective, it is unclear how the problems of quality of advice, disclosure and so on that I alluded to a moment ago are going to be able to be resolved within the current limited regulatory framework for investment advice about property.

You might also think the current arrangements raise *regulatory parity* issues for FSR-regulated industry sectors such as your own.

Let me make a further observation in this context. As many of you will know better than me, rental yields on residential investment properties have been very low in recent years. According to the Reserve Bank, at the end of 2003 gross yields on residential property had reached a very low 3.5% (with cash rates at approximately 2.5% after payment of rates, management fees, strata levies, maintenance etcetera). I understand that this compares unfavourably with, for instance, the 8-9% yields for industrial, office and retail property.

In this context, the Reserve Bank has commented that the industrial, office and retail yields are the sorts of yields required to get professional investors to invest in property, yet households are investing at less than half these yields.

Of course, investors have been willing to accept poor returns from earnings on residential property investment at least in part because they expected further speculative capital gains from housing—that is, gains over and above what might be expected from other types of investments.

What is striking about this situation, however, is that, among more recent investors, these stronger capital gains were apparently anticipated—and may still be anticipated—even though there have been consistently strong rises in housing prices for a number of years, including particularly strong rises in the last two years.

Equally striking is the fact, as I understand it, that speculative investment has been strongest in the Melbourne and Sydney markets which have already had the strongest recent capital gains (and where rental yields have been lowest).

The question I want to put to you is whether this suggests a level of *under-recognition* of the risks associated with investment in the property market and with 'bubble' pricing, in particular. In short, have average retail investors been sufficiently cognisant of the potential for a market correction, and the implications for their investments of such a correction?

And, if not, is this in part because the current regulatory framework governing advice about and promotion of direct investment in property is such that people are not getting enough information about the downside risks of investments, the incentives driving promoters' recommendations and so on?

With those questions hanging, I'll finish this presentation, thank you for listening, and invite your questions.