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Alternative Funds

Australia

Law and Practice
Michael Lawson, James Momsen,
Yoni Garson and Dong Su Kim
MinterEllison

Trends and Developments
Michael Lawson, Yoni Garson
and Thomas Daley
MinterEllison

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AUSTRALIA

Law and Practice

Contributed by:
Michael Lawson, James Momsen, Yoni Garson
and Dong Su Kim
MinterEllison see p.12

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1. General

1.1 General Overview of Jurisdiction

Australia is a jurisdiction that is welcoming to alternative fund strategies and managers. Whilst, historically, alternative asset classes were under-served by experienced managers and under-allocated to by investors, this environment is changing, with attractive tax treatment for private equity and venture capital strategies, and an increasing desire by institutional and high net worth investors to allocate capital to hedge, alternative credit and other private asset funds.

2. Funds

2.1 Types of Alternative Funds

The types of alternative funds that are commonly established in Australia include private equity, hedge, alternative credit and venture capital funds.

2.2 Fund Structures

The most commonly used structure is a unit trust, due to its flexibility.

For private equity and venture capital funds, a unit trust or a limited partnership, usually in the form of a venture capital limited partnership or early stage venture capital limited partnership (in certain circumstances), can be used. A unit trust is simpler to establish and offers greater flexibility with respect to the asset classes in which it can invest, however, certain limited partnerships can attract tax benefits for investors and fund managers where requisite requirements are met.

For hedge and credit strategies, a unit trust is the only suitable local structure.

Unit Trusts

Structure and regulation

In Australia, unit trusts can be structured as open- or closed-end vehicles, where performance fees can take the form of a traditional performance fee on net asset value increase or a private equity-style "carry waterfall".

There are very few legal requirements that apply to Australian unit trusts, which are simple to establish and, provided they are only offered to wholesale investors, often have no regulatory or other registration or approval requirements (note that there would typically be regulatory requirements for the manager or trustee, see section **2.3 Regulatory Regime**). Invariably, these vehicles can therefore be tailored to suit the bespoke fund design needs of a fund manager and investors.

These structures can be used to invest capital into any asset class, making it an attractive vehicle for many fund managers and investors. In addition, it is relatively easy to structure multiple unit classes in the one-unit trust, allowing for different fee options, the ability to gain exposure to multiple asset classes and other tailoring options to suit investor needs. Although partnerships are often used for PE and VC strategies where the tax regime allows, it is also very common to see unit trusts used for these strategies, due to their flexibility.

A unit trust is managed by its trustee, who may in practice appoint an investment manager to provide investment management services in respect of the trust. The use of corporate trustees is common by fund managers who either do not desire to manage the day-to-day administration of their own trust, or who may lack the necessary regulatory licence to act as a trustee.

Partnerships

In Australia the only form of corporate investment vehicle is an incorporated limited partnership.

The common partnership structures used by a private equity or venture capital fund to invest primarily in Australian businesses are known as venture capital limited partnerships (VCLPs) for private equity and venture capital funds or early-stage venture capital limited partnerships (ESVCLPs) for early-stage venture capital funds.

Overview of VCLPs and ESVCLPs

An incorporated limited partnership must meet specific requirements before it can be registered as a VCLP or an ESVCLP with Innovation and Science Australia, an Australian government department. There are specific requirements for a VCLP and an ESVCLP set out in the Venture Capital Act 2002 (Cth) (VC Act), with many consistencies between the two, including, but not limited to:

- the term of the partnership must be more than five years and less than 15 years;
- the minimum committed capital is at least AUD10 million; and
- the partnership must only carry on activities that are related to making eligible venture capital investments, as defined by relevant Australian tax legislation.

An EVCI is an equity investment in an unlisted company or unlisted trust that is located in Australia, does not exceed more than 30% of the partnership's committed capital and which has a predominant activity that is not an ineligible activity. An ineligible activity includes property development or land ownership, banking, providing capital to others, leasing, factoring, securitisation, insurance, construction or acquisition of infrastructure facilities and/or related facilities, and making investments that are directed at deriving income in the nature of interest, rent, dividends, royalties or lease payments. In order for an investment to qualify as an EVCI, the investment must not exceed the value restriction imposed at the time of the investment (ie, AUD50 million for an investment by ESVCLP and AUD250 million for an investment by VCLP).

In addition to the requirements for registration, the VC Act applies various restrictions to these structures:

- no single investor in an ESVCLP, other than in certain defined circumstances, can contribute more than 30% of the total committed capital;
- the maximum committed capital for an ESVCLP is AUD200 million;
- VCLPs and ESVCLPs cannot invest in a single investment whose total assets exceed AUD200m at the time of investment; and
- in general, cannot make debt investments other than permitted loans as defined in the VC Act.

Given the strict requirements and restrictions imposed on VCLPs and ESVCLPs, many fund managers establish these vehicles together with parallel funds (usually soft stapled-unit trusts). This structure allows fund managers to obtain the tax benefits afforded to VCLPs and ESVCLPs in respect of investments which are EVCIs, whilst providing the fund manager the flexibility to invest in non-EVCIs via the parallel funds. This has been a common strategy for leading Australian private equity and venture capital funds.

2.3 Regulatory Regime

Entities managing alternative funds should either hold an Australian financial services licence (AFSL) with appropriate authorisations, be appointed as the authorised representative of the holder of an AFSL or otherwise fall within a relevant licensing exemption under the Corporations Act 2001 (Cth) (Corporations Act). Where the fund is a unit trust, both the trustee and the manager should have the appropriate authorisations in respect of managing, and issuing, interests in a managed investment scheme. Where a foreign manager wishes to offer an Australian fund, it is common to appoint a corporate trustee as the trustee of the fund, who would appoint the manager as the investment manager of the fund (see **3.8 Local Regulatory Requirements for Non-local Managers** regarding regulation of the manager).

The regulatory requirements applicable to a fund manager differ depending on whether the fund manager accepts investments from retail or wholesale clients. Generally, wholesale clients are sophisticated investors who satisfy relevant financial means tests under the Corporations Act or who have sufficient experience and market knowledge. Anyone who is not a wholesale client is a retail client. Frequently, alternative funds will be primarily suitable for wholesale investors. This is because it is unattractive for fund managers to offer such products to retail investors due to the costs of licensing and compliance, level of disclosure required and rules concerning liquidity.

From a regulatory perspective, alternative funds open to wholesale clients only operate with relative freedom.

There are very few limitations applying to alternative funds. Significantly for private equity funds, there are adverse tax implications if a trust were to control a business such that it would be designated a "trading trust". In such a case, the trust would potentially not be eligible to qualify as a managed investment trust and potentially could be like a company (where the trust is widely held). The concept of "control" is currently widely interpreted for Australian income tax purposes.

In certain circumstances, including where 20% of the interests in an Australian fund are held by a foreign entity or 40% of the interests in aggregate in an Australian fund are held by foreign entities and their associates, approval may be required by the Foreign Investment Review Board (FIRB) in respect of the investments of such fund.

2.4 Loan Origination

Funds can originate loans and alternative credit funds are becoming significant competitors to Australian banks as providers of finance at all levels of the capital stack, including as senior secured, subordinated and mezzanine financiers.

Where loans are provided to consumers, the lender may need an Australian Credit Licence; however, this is not typical for alternative credit funds.

The origination and provision of loans is not generally a financial service and accordingly (other than in respect of consumer loans) no regulatory licensing is necessary for this activity. However, management or promotion of a credit fund will constitute a financial service and regulatory licensing will usually be required, as discussed in **2.3 Regulatory Regime**.

Where a fund originates loans and itself is the relevant lender of record, any borrower fees paid to the fund will often be exempt from applicable sales tax.

2.5 Cryptocurrencies and Non-traditional Assets

There is no rule that prevents funds from investing in cryptocurrencies or other non-traditional assets. However, a fund manager should ensure that they are properly licensed to provide financial services in respect of these asset classes.

Cryptocurrencies may, depending on their functionality, be designated as securities, derivatives, non-cash payments or interests in a managed investment scheme. These financial products require separate authorisations on a manager's AFSL. Accordingly, prior to providing financial advice or dealing in non-traditional assets, it would be necessary to consider carefully the category of financial product into which the relevant asset would fall.

The Australian alternatives' landscape has seen funds investing into other non-traditional assets, such as fractional real estate and royalties.

2.6 Regulatory Approval Process

A regulated fund (typically, an Australian unit trust) is known as a registered managed investment scheme, meaning that it is registered with the Australian Securities and Investments Commission (ASIC). The registration process is relatively straightforward and only requires that:

- the trustee of the fund holds an AFSL authorising it to be a "responsible entity" of a registered managed investment scheme;
- the responsible entity is an Australian public company; and
- the constitution of the fund meets the requirements of the Corporations Act.

Once an application for registration is received by ASIC, a decision on registration must be made within 14 days.

2.7 Requirement for Local Investment Managers

A foreign domiciled manager may be appointed as the investment manager of an Australian fund, provided the foreign manager complies with Australian financial services licensing requirements, as discussed in **3.8 Local Regulatory Requirements for Non-local Managers**.

Generally, the licensing requirements with which a foreign manager must comply or relevant exemptions on which it may rely will depend on whether the foreign manager provides financial services to retail or wholesale clients and the class of financial products in respect of which it provides financial services.

2.8 Other Local Requirements

Licensing

In general, there are no locality restrictions in the Australian fund management universe. As long as a manager complies with the Australian financial services licensing regime, the manager can be located entirely offshore.

However, a registered managed investment scheme must have as its trustee a "responsible entity", which, amongst other things, must be an Australian public company as set out in **2.6 Regulatory Approval Process**.

Partnerships

VCLPs and ESVCLPs can be registered where the partnership was established as a limited partnership in a foreign country that has a particular category of double taxation agreement with Australia and where all the partnership's GPs are resident in such a country. In addition, the partnership would still need to meet the same requirements as Australian partnerships for these purposes. The manager for the partnership can be located offshore. In these circumstances, if a financial service is being provided in Australia – which would be likely unless all investors were offshore – both the GP and the manager may need to comply with Australian financial services licensing laws (see **3.2 Regulatory Regime** and **3.8 Local Regulatory Requirements for Non-local Managers**).

Trusts

Whilst a foreign entity can be the trustee of an Australian unit trust, licensing requirements have made this fairly uncommon. Foreign managers wishing to establish an Australian vehicle (such as a hedge, private equity, venture capital or credit fund) typically hire an Australian corporate trustee to perform this role and arrange local licensing for the management entity separately.

Where a foreign entity is the trustee of an Australian unit trust, the trust is unable to qualify as a managed investment trust (see in **2.11 Tax Regime** the tax benefits of qualification as a managed investment trust).

2.9 Rules Concerning Other Service Providers

In Australia, there are generally no requirements as to the choice and location of service-providers, including administrators, custodians and fund administrators.

2.10 Requirements for Non-local Service Providers

Non-local service providers are typically not subject to regulation or registration requirements, on the basis that they would not be providing the financial services in Australia for the purpose of relevant legislation. An exception to this may be where the non-local service-provider provides anti-money laundering (AML) compliance services, in which case they may be required to register with AUSTRAC, the AML regulator.

2.11 Tax Regime

Taxation of a Trust

Typically, the income and gains of a trust are subject to flow-through tax treatment (ie, taxable income of a trust is taxed at the hands of the investors) and therefore, investors are taxed directly on their pro rata share of the income of the trust and gains arising from the disposal of any investment of the trust.

Where the trust qualifies and elects to be a "managed investment trust" (broadly, the trust needs to be (i) managed by an AFSL holder, (ii) widely held, (iii) not closely held and (iv) cannot control a trading business in order for the trust to qualify as a "managed investment trust"):

- fund payment distributions made by the managed investment trust to foreign investors may be subject to the concessional managed investment withholding tax of 15%;
- investors' share of the gains arising from disposals of investments by the funds should be taxed under the capital gains tax provisions (where certain election has been made by the trust). As a result, potential CGT discount may be available for eligible Australian resident investors.

Taxation of VCLP or ESVCLP

A VCLP or ESVCLP provides fund managers and investors with support to help stimulate venture capital investments by way of tax benefits.

For a VCLP, the key Australian tax implications include:

- "flow-through" treatment – taxable income derived by the VCLP "flows through" the partnership to the investors and will be taxed in the hands of the investors; and
- "CGT exemption" – a full capital gains tax (CGT) exemption is available for eligible venture capital partners (ie, tax-exempt foreign residents or foreign venture capital funds) on gains derived from disposal of EVCIs made by the VCLP (subject to satisfying certain requirements).

For an ESVCLP, the key Australian tax implications include:

- "flow through" treatment – taxable income derived by the VCLP "flows through" the partnership to the investors and will be taxed in the hands of the investors;
- "tax offset" – a non-refundable carried-forward tax offset is available to investors for the lesser of either 10% of their eligible contributions or share of investments in the ESVCLP (subject to satisfying certain requirements);
- "revenue gain or profit exemption" – any revenue gain or profit arising from the disposal of an EVCI by an ESVCLP will be excluded from the taxable income of an investor of the ESVCLP. This applies only if the revenue gain that arises would have been subject to the CGT exemption if the asset disposed of was a CGT asset. Note that the exemption is capped where the relevant investment exceeds AUD250 million; and
- "income exemption" – an investor's share of income (eg, dividend) derived from EVCIs made by an ESVCLP will be excluded from the partner's taxable income calculation if the partner is a limited partner of an Australian-resident general partner.

2.12 Double-Tax Treaties

Generally, a trust as a resident should be able to qualify for the benefits of a double tax treaty between Australia and a foreign jurisdiction. However, this should be considered on a jurisdiction-by-jurisdiction basis.

Note that there are limitations on VCLPs/ESVCLPs investing in foreign jurisdictions. Accordingly, it has not been considered further as to whether a VCLP/ESVCLP can qualify for benefits under double-tax treaties.

Similar to a trust, a VCLP/ESVCLP should be treated as a flow-through entity for Australian income tax purposes. Accordingly, the benefits under double-tax treaties would need to be considered by a foreign partner (along with any Australian tax concessions) in determining the Australian tax implications of their share of the VCLP/ESVCLP 's taxable income.

2.13 Use of Subsidiaries for Investment Purposes

The use of subsidiaries for investment purposes is common in a unit trust in order to effect segregation of the assets of one class of units from others and ring-fence legal liability in respect of underlying investments. Subsidiaries may also be useful where investors external to a fund co-invest into an asset, in situations where the manager desires to retain control of the asset or charge fees to the co-investors.

2.14 Origin of Promoters/Sponsors of Alternative Funds

Typically, promoters or sponsors would come from Australia; however, fund managers frequently use offshore promoters in order to target foreign investors, particularly in Europe and North America.

2.15 Origin of Investors in Alternative Funds

Most investors in Australian alternative funds are Australian-domiciled; however, it is not unusual to see significant foreign capital invested in Australian funds, particularly private equity funds and venture capital funds.

2.16 Destination of Investments Made by Alternative Funds
Most Australian alternative investment funds focus on investments in Australia, New Zealand and the Asia Pacific region.

2.17 Key Trends
As previously mentioned, alternative credit strategies are increasingly common in the current environment as sophisticated investors look to derive alpha from fixed interest returns whilst having the flexibility of frequent liquidity options typically offered by alternative credit strategies.

Alternative credit strategies range from highly illiquid private-equity style locked-up vehicles with carry waterfalls, to products mimicking hedge fund arrangements, often with high watermarks. These managers are becoming desirable lenders and are often able to enhance returns to investors by acquiring nuanced hybrid investments, thus creating a fund with equity-like return features but with regular income distributions.

Certain investors have shown a reluctance to lock away significant capital in a blind pool structure for long periods of time. Whilst they may be comfortable with long-term investments, many investors look for greater control over asset allocation and investment choice.

Accordingly, there has been an increase in managers enabling investors to choose the assets they invest in. Managers typically form "deal-by-deal" special-purpose vehicles (SPVs) with carry terms. However, this trend has created increased pressure on managers who are forced to bear any aborted deal costs in respect of such structures.

In the institutional private equity universe, pressure on "outside fees" has increasingly caused managers to repay investee payments back into the fund, although often in deal-by-deal transactions, where management fees are typically lower, this point has proved negotiable.

The private equity secondaries market is one that is of interest to many investors; however, to date, there have not been wide-scale secondary sales or capital call pressures to enable the birth of a true secondary private equity fund sector in Australia.

2.18 Disclosure/Reporting Requirements
There are generally no specific disclosure or reporting requirements applicable to Australian wholesale alternative funds. In respect of such funds, managers will commonly issue an "information memorandum" or "private placement memorandum" in connection with the offer of interests in the fund. Where such disclosure documents are issued by a manager, a fundamental requirement is that such disclosures do not contain statements which are misleading or deceptive, including by omission.

Funds offered to retail clients are subject to strict disclosure requirements, as mandated by the Corporations Act and associated regulations.

2.19 Anticipated Changes
Income Tax
As previously described, in order for a trust to qualify as a "managed investment trust", the trust is not able to "control" a trading business. The Australian Taxation Office is currently considering the concept of "control" for trading trust purposes (which impact the managed investment trust requirements), which could impact "managed investment trust" structures going forward.

Build-to-Rent Arrangements
There are changes being made to the goods and services tax (GST) and land tax implications arising from "build-to-rent" arrangements, which should be considered by investors/alternative funds making such investments.

3. Managers

3.1 Legal Structures Used by Fund Managers
Alternative fund managers themselves are typically structured as Australian proprietary companies limited by shares. However, fund managers' internal structures often provide that the management entity may contract with other internal entities for the provision of investment advisory services to mitigate any tax and legal exposure.

3.2 Regulatory Regime
A fund manager would need to hold, or be otherwise authorised under, an AFSL issued by ASIC. It is common for managers who do not hold an AFSL to be authorised under another AFSL holder's licence. The relevant AFSL or authorisation would need to authorise the manager to perform a variety of financial services, such as:

- provide financial product advice in respect of securities, interests in managed investment schemes and derivatives; and
- issue of interests in the relevant class of financial products (or arrange for the issue of these).

As discussed further in section **3.8 Local Regulatory Requirements for Non-local Managers**, foreign managers may rely on funds management relief or apply for a foreign AFSL which is a limited AFSL for foreign managers providing financial services to wholesale clients. In certain circumstances, a foreign manager may be required to register as a foreign company in Australia, where it is carrying on a business in Australia.

3.3 Tax Regime

Management fees (including performance-based fees) paid to a fund manager from a trust should be treated as assessable income for Australian income tax purposes. Consideration should be given to whether any benefits under the relevant double tax treaty are available for management fees received by a foreign-resident fund manager.

Management fees (excluding performance-based fees) paid to a fund manager from a VCLP/ESVCLP should be treated as assessable income for Australian income tax purposes. Consideration should be given to whether any benefits under the relevant double tax treaty are available for management fees received by a foreign-resident fund manager.

Income tax implications arising from "carried interests" are outlined in **3.5 Taxation of Carried Interest**.

3.4 Rules Concerning "Permanent Establishments"

The "investment manager regime" (IMR) provisions under the Australian Income Tax system provide an exemption for returns or gains that would otherwise be assessable income of a fund for Australian income tax purposes, only because these returns or gains are attributable to a permanent establishment in Australia which arises solely from the use of an Australian-based manager.

Broadly, this exemption is only applicable for an IMR financial arrangement (ie, a financial arrangement excluding a financial arrangement that is, or relates to, a CGT asset that is taxable Australian property) that has been made on behalf of an IMR entity (ie, a non-resident entity (regardless of the type)) by an independent Australian fund manager. In addition, the exemption requires the IMR entity to have less than 10% interest in the counterparty to the IMR financial arrangement and the IMR entity not to carry on a trading business in Australia.

The requirements that need to be satisfied to obtain this exemption are complicated and therefore, careful consideration is required.

3.5 Taxation of Carried Interest

Where structured appropriately, carried interest received by a fund manager from a VCLP/ESVCLP should be subject to concessional capital gains tax treatment.

Carried interest received by a fund manager from a trust should be treated as ordinary assessable income of the fund manager. No capital gains tax discount should be available for the fund manager under this scenario.

3.6 Outsourcing of Investment Functions/Business Operations

Australian managers can outsource many of their investment functions and business operations with relative freedom. If outsourcing investment functions, it is likely that the provider of investment services would be required to hold an AFSL or otherwise be authorised by the holder of an AFSL.

The outsourcing of business operations is generally beyond the scope of financial services regulation, other than in respect of anti-money laundering services. Compliance with anti-money laundering legislation is required by the issuer of interests in the relevant fund. This function can be outsourced and it is likely that the person undertaking such services will be required to register with AUSTRAC, the Australian AML regulator.

Where an investment manager is engaged by a regulated superannuation fund to provide investment management services in respect of a portfolio, there are specific regulatory requirements in respect of business continuity, disaster recovery, cybersecurity and providing such services offshore.

3.7 Local Substance Requirements

There are no relevant requirements specific to Australian fund managers. However, where a manager holds an AFSL it is subject to strict conditions (both financial and non-financial) under the AFSL and associated legislation with which it must comply, including having adequate financial and operational resources to carry on its financial services business.

3.8 Local Regulatory Requirements for Non-local Managers

A non-local manager is bound by Australian financial services laws if it provides financial services in Australia and is required either to rely on applicable funds management relief, apply for a foreign AFSL, which is a limited AFSL for foreign managers providing financial services to wholesale clients, or apply for an AFSL.

There are three main options for a foreign manager to provide funds management financial services to Australian wholesale clients.

Funds Management Relief

Where the financial services are provided to:

- responsible entities of registered schemes;

- superannuation trustees if the fund has at least AUD10 million net assets;
- licensed trustees of wholesale trusts;
- banks and insurance companies;
- companies regulated by the Australian Prudential Regulation Authority (APRA); and
- government authorities,

and where the manager:

- does not have a place of business in Australia;
- holds a licence for such conduct in its home jurisdiction where the regulator is a signatory to the IOSCO MMU Concerning Consultation and Cooperation and Exchange of Information,

under this regime, a foreign funds manager will be able to:

- provide advice;
- deal in financial products and make a market; and
- provide custodial or depositary services,

in respect of an offshore fund.

Foreign AFSL (FAFSL)
This regime allows FFSPs to provide a wider range of financial services to any wholesale client in Australia, provided it is regulated by the:

- Danish FSA;
- French AMF or ARPR;
- German BaFin;
- Hong Kong SFC;
- Luxembourg CSSF;
- Ontario OSC;
- Singapore MAS;
- Swedish FI;
- UK FCA; or
- US SEC,

(among other regulators), subject to the relevant authorisations on that licence.

An FAFSL does not impose the same obligations, nor does it have the same application burden, as an AFSL, however, the application process does require submissions relating to the persons providing and responsible for the financial services.

Authorised Representative
It is possible for a person to be authorised to provide financial services by the holder of an AFSL. Under this exemption, an AFSL holder would be required, in writing, to allow, and be responsible for, the provision of relevant financial services by the FFSP.

4. Investors

4.1 Types of Investor in Alternative Funds
Alternative funds are frequently invested in by institutional investors from both Australia and offshore. Most major Australian institutional investors have an allocation for private equity funds.

Typical investors into Australian alternative funds include high net worth investors, family offices, superannuation funds, partnerships, sovereign wealth funds and national and international alternative investment managers. In the last 12 months the alternative funds sector has seen significant growth in assets under management from Australian and foreign investors. It is common to see alternative funds attracting capital from all categories of wholesale investors. Venture capital strategies have commonly been more popular among HNW and family-office investors than institutional investors, with certain notable exceptions.

4.2 Marketing of Alternative Funds
Alternative funds can be marketed to any client in Australia, as long as the person marketing the fund is authorised under an AFSL (or an exemption – see **3.8 Local Regulatory Requirements for Non-local Managers**) to provide financial product advice, or deal in the relevant fund interests to the relevant client group. Typically these funds would be marketed to wholesale clients only.

If the person is not authorised to provide these services to retail clients, then marketing activities must be limited to wholesale clients. In addition, where the fund is distributed to retail clients it would usually need to be registered with ASIC as a "registered managed investment scheme" (see **2.6 Regulatory Approval Process** and **2.8 Other Local Requirements**) and comply with regulated disclosure requirements (see **4.5 Regulatory Regime**) and associated rules applying to regulated products.

4.3 Rules Concerning Marketing of Alternative Funds
As previously stated, any person (including a firm) must hold (or be otherwise authorised under) an AFSL authorising the provision of financial product advice to the relevant client group, namely, retail or wholesale clients (as the case may be). The AFSL authorisation must relate to the specific type of financial product that is to be marketed (typically, securities or interests in a managed investment scheme).

A firm that is not domiciled in Australia will be able to market funds in Australia as long as they comply with the licensing regime for foreign financial service-providers. A foreign firm will be able to provide financial services to Australian wholesale clients if they satisfy the requirements of relevant funds management relief or hold an FAFSL. It is worth noting that a foreign firm is not able to market funds to Australian retail clients unless it holds, or is otherwise authorised under, an AFSL. There also exists temporary, very limited relief, that may allow an offshore person to engage in limited marketing to wholesale clients in certain circumstances.

As an alternative, it may be possible for a foreign firm to provide financial services in Australia as an authorised representative of a holder of an AFSL.

4.4 Local Investors

Local investors are generally able to invest in alternative funds established in Australia.

4.5 Regulatory Regime

Typically, there are no required regulatory filings or marketing documents required in respect of alternative funds marketed to wholesale clients.

The most likely exception is where the fund is a registered managed investment scheme and fund interests are issued to retail clients. Those fund interests would typically be required to be issued pursuant to a regulated disclosure document, known as a product disclosure statement (PDS), and an "in-use" notice would be required to be filed with ASIC. In these circumstances, there are regulatory obligations in respect of continuous disclosure notices to be filed with the regulator, as well as the requirement for, in the event of open-end funds, the PDS to be materially correct at all times. In addition, if it is proposed that the fund is listed on the Australian Securities Exchange (ASX), the PDS would be required to be provided to ASIC for review and lodged with the ASX, in addition to complying with relevant disclosure requirements under the Corporations Act.

4.6 Disclosure Requirements

A fundamental disclosure requirement is that communications to investors cannot be misleading or deceptive, including by omission.

Where retail investors are being issued with interests in a fund, the PDS must comply with statutory disclosure rules, including detailed costs' disclosure and the issuer of the product has ongoing continuous disclosure obligations.

4.7 Tax Regime

As previously discussed, taxable income of a trust, VCLP or ESVCLP is generally taxed at the hands of the investors. For Australian income tax purposes, different kinds of investors are subject to different taxation principles and taxation rates (eg, corporates are taxed at the corporate tax rate (generally 30% unless a complying small business), individuals are taxed at the relevant marginal tax rate (the highest being 45%) and complying superannuation funds are taxed at a rate of 15%). It should be noted that tax concessions may be available for foreign pension funds and sovereign wealth funds.

Given the complex nature of the Australian taxation system, consideration should be given by an investor to the application of the Australian income tax provisions based on the facts and circumstances of the investor.

Where a capital gain has been derived by an Australian investor from its investment in a trust/VCLP/ESVCLP (ie, as a result of a disposal of a capital asset by the investment vehicle or a disposal of an interest in the investment vehicle), the capital gain could be subject to a discount where the relevant asset has been held for at least 12 months and the investor is a qualifying taxpayer (ie, not a company).

Where a capital gain has been derived by a non-resident investor from its investment in a trust/VCLP/ESVCLP (ie, as a result of a disposal of a capital asset by the investment vehicle or a disposal of an interest in the investment vehicle), the capital gain could be exempt if the relevant asset is taxable Australian property. No capital gains discount is available for non-resident taxpayers.

Where a non-resident investor disposes of an asset that qualifies as taxable Australian property (eg, interest in a land-rich Australian fund), the purchaser will be required to withhold 12.5% of the purchase price and remit this amount to the Australian Taxation Office. The non-resident investor should be able to claim a tax credit for the amount withheld (which could be refundable if the tax liability of the non-resident investor is lower than the withheld amount).

There are special or preferential tax treatments available for investors of a VCLP/ESVCLP as previously outlined.

4.8 FATCA/CRS Compliance Regime

FATCA

Entities that are treated as "Reporting Australian Financial Institutions" under the FATCA Agreement between Australia and the United States (which broadly includes banks, private equity funds, and managed funds) are required to provide the following information about their "US Reportable Accounts" (as defined in the FATCA Agreement) to the Australian Taxation Office no later than July 31st in the following income year:

- account holder's name, address, account number;
- US tax-identification number;
- account balance or value of the account at the end of the relevant period; and
- name and identifying number of the institution.

For completeness, note that "Reporting Australian Financial Institutions" only have obligations to provide the requisite FATCA information to the Australian Taxation Office (and not to the IRS).

CRS

Australia has signed the OECD Multilateral Competent Authority Agreement on Automatic Exchange of Account Information. Entities that are treated as "Reporting Financial Institutions" under the CRS (ie, Part II.B of the Standard for Automatic Exchange of Financial Account Information in Tax Matters) are required to provide certain information regarding a Reportable Account under the CRS to the Australian Taxation Office no later than July 31st in the following income year.

The CRS reporting obligations of a Reporting Financial Institution under the Australian Tax Act should be broadly consistent with the CRS Commentary (ie, Part III.B of the Standard for Automatic Exchange of Financial Account Information in Tax Matters). The Australian Tax Act does make certain specifications to clarify how the Reporting Financial Institutions are to apply the due diligence procedures contained in the CRS and the CRS Commentary for the purposes of the Australian Taxation Law.

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Authors

Michael Lawson is a partner and leads MinterEllison's capital solutions and funds management group. He has advised Australian and global fund managers on all aspects of funds management and financial services for over 20 years. He has broad industry experience across domestic and international financial products, including retail and institutional funds, A-REITs, ETFs, structured products, private equity funds, hedge funds and infrastructure funds. Michael's expertise spans the development, formation and promotion of listed and unlisted investment funds, restructures of existing products, counterparty arrangements, and regulatory issues. Before joining MinterEllison, Michael was part of magic circle Clifford Chance's market-leading funds management team in London.

James Momsen is a partner and a transactional income tax adviser with 15 years of experience in Australia and overseas. He has a track record in providing Australian tax due diligence and structuring assistance to domestic and international clients entering into an M&A or capital markets transaction, or requiring Australian corporate tax advice. Prior to joining MinterEllison in 2017, James was a director in a big-four accounting firm's corporate M&A, PE, infrastructure and international tax team, where he acted for corporate and private equity clients with interests in Australia. He also spent time in that firm's New York office managing the Australian tax desk.

Yoni Garson is a senior associate in MinterEllison's alternative investments group. Prior to entering private practice, Yoni worked for an award-winning UK-based alternative investments manager. Yoni has experience in regulatory matters, corporate restructurings, funds/trust restructurings, funds establishment and general corporate advice. He regularly acts for domestic and international alternative managers on fund formation, fundraising and negotiations as well as carry-structuring and regulatory matters. Yoni's expertise spans hedge, private equity, VC and credit acting for many of Australia's leading managers in establishing vehicles in these strategies. Yoni also regularly represents institutional investors when allocating to alternative funds and establishing mandates.

Dong Su Kim is a senior associate in the firm's corporate tax team. He is a transactional tax adviser with six years of experience advising domestic and international clients engaged in venture capital, private equity, property and infrastructure transactions. He also provides ongoing corporate income tax advice to clients on various domestic and international tax issues. In his role, he acts as a liaison between the tax team and other practices of the firm, providing clients with seamless legal and tax advice. Prior to joining MinterEllison, Dong Su was a senior consultant in a big-four accounting firm's M&A and international tax team.

MinterEllison

Level 40
Governor Macquarie Tower
1 Farrer Place
Sydney
NSW 2000
Australia

Tel: +61 2 9921 8888
Fax: +61 2 9921 8123
Email: michael.lawson@minterellison.com
Web: www.minterellison.com

MinterEllison

Trends and Developments

Contributed by:
Michael Lawson, Yoni Garson and Thomas Daley
MinterEllison ***see p.16***

The Australian investment fund landscape over the past 12 months has seen changes with differing effects for fund managers of both traditional and alternative funds from a commercial and regulatory perspective.

Commercial Trends

Changes in the investor landscape

Historically, it has been noted that the sophisticated and high net worth (HNW) investor community has been under-served by the alternative funds industry, especially where private equity and alternative credit is concerned. These strategies have, for the most part, been the domain of large superannuation funds and other institutional investors. Individual HNW investors have often lacked the ticket size to invest in these (particularly private equity) funds and may not have had the manager research capabilities to gain access to quality alternative funds in general.

This landscape has begun to shift as HNW investors search for stronger, and less correlated, performance away from traditional strategies towards private market opportunities, and managers are under growing pressure from many institutional investors regarding fees and carry. Magnifying this situation is the desire of institutional investors to invest directly in deals, often as direct co-investors, rather than into a pooled fund.

Increasingly, aggregators of HNW capital, such as wealth managers and wholesale platforms, have sought to add value to their own clients by offering access to these opportunities. This has taken the form of "white label" direct funds, feeder funds, or simply facilitating a manager's products to be offered on wealth-management platforms.

A concern among certain platforms has been managing capital call and redraw/claw-back risk, where the platform is the investor of record, but the investments are client-directed, or where the platform simply acts as an aggregator. These concerns are capable of alleviation, both through tailoring of the platform's terms and conditions, and also by subscription or side-letter arrangements with general partners - GPs/fund managers who, in Australia, are usually sympathetic to these requirements. In any event, aggregators who wish to offer capital call products to investors should carefully consider their arrangements with their investors and the target funds to manage this risk.

Strategies and capital-raising

Australia's capital in private equity and venture capital has continued to rise. In the half year ending in June 2019 assets grew by 16%, according to Preqin, with Australia-focused private equity (PE) assets hitting AUD25 billion and combined PE and venture capital (VC) firms having a total of AUD33 billion in assets (according to the Australian Investment Council).

Credit has been a strategy of significant importance to investors, as investors have sought to use private debt as a way to gain exposure to local corporates. Local private debt managers have capitalised on the institutional and traditional processes of the major banks and seek to disrupt the dominance of these banks as go-to lenders for many corporates. In offering these strategies, local wholesale investors have been able to access more aggressive fixed-income returns that are still on a capital base and benefiting from traditional lender protections. In some instances, these strategies have also been made available to retail investors. The increased desire for alternative credit strategies has led to many managers seeking to expand their private debt capabilities and launch private debt funds.

In the current COVID-19 environment, certain institutional investors have become increasingly sensitive to the liquidity profile of their portfolios, as Australian superannuation funds have been required, under legislative relief packages, to offer members additional withdrawal rights. In the short term, this has seen an institutional movement to deploy capital to income products and other strategies which offer frequent liquidity rights as a means to manage their ability to satisfy redemption requests.

There have been a number of high-profile private equity capital raises in the mid-market space by some of Australia's leading GPs, with others completing final closes on earlier raises. Australia's private equity community has benefited from strong interest and allocations by the global PE investment universe, with many leading global allocators taking limited partner (LP) positions in Australian raises.

Australia has continued to be a source of outgoing capital for foreign managers, who have successfully raised capital in PE and credit from major Australian institutional investors.

There is much talk about the Australian HNW community being an untapped source of capital for foreign managers. Increasingly, placement agents and wealth managers are seeking to provide

Australian HNW investors and other non-institutional wholesale investors with options to access high-performing foreign fund managers in PE, credit and VC.

Certain groups with a strong HNW client portfolio have established fund of funds-style vehicles and built good relationships with first-tier foreign managers in order to aggregate HNW capital to meet minimum ticket sizes. These vehicles would usually take the form of a local unit trust. In addition, there are a number of HNW wealth managers representing sufficient capital to write institutional level ticket sizes that have been seeking to act as feeders to both local and foreign alternative funds. These might take the form of feeder vehicles, or white-labelled mandates.

Venture capital has had an exceptionally strong year, with in excess of USD430 million injected into Australian start-ups during the quarter of April-June 2020.

Investor preferences

Arguably, the most noticeable change from previous years has been the desire of investors (both institutional and HNW) to have more say over investment decision-making. There has been a definite increase in vehicles enabling investors to choose the deals to which they are exposed. This may occur in deal-specific SPVs, in single funds whereby deals are segregated into different classes or multi-class fund structures with both a "blind pool" and "pledge pool" investment option. The challenge some managers have faced with this reality is that they are not always able to pass on aborted deal costs to investors.

Some managers have opted for a "club" approach, whereby investors pay an initial commitment fee to gain access to manager-originated deal-flow, enabling managers to be compensated for origination. Where an investment is identified early, many investors have been willing to underwrite due diligence and transactional costs in the event of an aborted deal. This is a process that is expected to develop further as managers find more sophisticated ways to offer cherry-picking of deals whilst not bearing all the costs of aborted transactions.

Institutional investors have for some time been searching for solutions to gain direct access to alternative investment opportunities. These have often taken the form of investing directly, and appointing a manager to manage the assets, or forming a single-purpose mandate vehicle and appointing the investment manager for a fixed term. Some institutional investors have shown a willingness to use this approach to access offshore opportunities, and foreign managers have been appointed to manage a fund of one for these investors.

Across the board, investors continue to seek to gain preferential fees in pooled vehicles. Whilst larger managers have often been in the position to hold firm on management fees and carry, smaller managers have often struggled to raise on a "two and 20" model.

Regulation

Of particular relevance to international fund managers are the changes effected by the Australian Securities and Investments Commission (ASIC) in respect of foreign financial services providers (FFSPs). Whereas in the past, it was a fairly simple exercise for FFSPs who were licensed in the US, UK, Hong Kong, Germany and Singapore to provide financial services to sophisticated investors in Australia, this regime has been replaced by a two-tier system.

The equivalency relief is maintained for those jurisdictions (plus Denmark, France, Luxembourg, Ontario and Sweden), but only in respect of certain categories of investors – mostly, large institutional investors or trustees of regulated funds. In other instances, a foreign manager would need to apply to ASIC for a foreign licence to market funds to wholesale investors or to be appointed as the manager of many local funds. The "limited connection" exemption, allowing one-off infrequent marketing, will remain until 2022. Some offshore managers have sought to deal with this change by becoming appointed representatives of Australian licence-holders, falling under a statutory exemption.

Whilst this regulatory environment is more burdensome, it is not expected to alter significantly the ability or desire for foreign managers to access the Australian market.

Certain managers, in recent years, have sought to raise capital by listing funds, or feeder funds on the Australian Securities Exchange. This has allowed for retail investors (as well as institutional investors) to access alternative strategies with the potential for liquidity. Regulatory changes have made it more difficult for these strategies to be marketed to retail investors, as rules about payment of commissions to brokers have been tightened. Whilst there are legal solutions to this change, the market has yet to respond.

Summary

Australia is clearly a growth market for alternative fund managers. Both local and foreign managers benefit from sophisticated institutional investors with the desire and ability to invest in alternative strategies, together with an HNW market with significant capital power whose allocation to alternative funds has probably not been fully utilised. In addition, foreign investors looking to diversify away from their home jurisdictions are able to access a community of sophisticated and strongly performing fund managers who are open to delivering investment terms consistent with other global alternative funds.

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Thomas Daley is a lawyer in MinterEllison's alternative investments group. Thomas specialises in private equity, venture capital, credit, hedge and other alternative investment strategies and acts for many leading domestic and offshore alternative investment managers in connection with the structuring, formation, promotion and negotiation of their investment funds and associated carry structures. Thomas' practice extends to advising institutional investors in respect of their investments into such funds, both domestically and offshore.

MinterEllison

Level 40
Governor Macquarie Tower
1 Farrer Place
Sydney NSW 2000
Australia

Tel: +61 2 9921 8888
Fax: +61 2 9921 8123
Email: michael.lawson@minterellison.com
Web: www.minterellison.com

MinterEllison