

THE ASSET
MANAGEMENT
REVIEW

SEVENTH EDITION

Editor
Paul Dickson

THE LAWREVIEWS

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REVIEW

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PREFACE

While the global financial crisis of 2007 and 2008 may feel like an increasingly distant memory, its effects continue to be felt across the whole of the financial world. Despite significant improvements in the global economic landscape in the intervening years, global growth has been hampered in recent years by various geopolitical factors, including political uncertainty resulting from the change in administration in the US in 2016 and the rise of populist movements in Europe. As the UK prepares for Brexit, absent any agreement to the contrary currently set to take place in March 2019, political uncertainty remains around the form and extent of any UK–EU deal relating to financial services, and as to whether any transition period (during which UK firms would remain able to access to EU markets on current terms) will be agreed. This has had, and is likely to continue to have, a potentially destabilising effect on the UK asset management sector and its clients. The impact of the UK’s decision to leave the EU is thus already being felt, not only in the UK and across the European continent, but also more widely.

Nevertheless, the importance of the asset management industry continues to grow. Nowhere is this truer than in the context of pensions, as the global population becomes larger, older and richer, and government initiatives to encourage independent pension provision continue. Both industry bodies and legislators are also increasingly interested in pursuing environmental, social and governance goals through private sector finance. For example, the European Commission has proposed a package of measures seeking to introduce sustainable finance into current regulations to make it easier for investors to identify and invest in such projects.

The activities of the financial services industry remain squarely in the public and regulatory eye, and the consequences of this focus are manifest in ongoing regulatory attention around the globe. Regulators are continuing to seek to address perceived systemic risks and preserve market stability through regulation. In Europe, further significant changes to the regulatory landscape for investment services were introduced by the revised Markets in Financial Instruments Directive regime (known as MiFID II), which has applied since 3 January 2018. In the UK, the Financial Conduct Authority continues to focus on the asset management industry. In 2017, it published its asset management market study on the performance of the asset management market for retail and institutional investors, and is beginning to implement its findings during the course of 2018. In contrast, the Trump administration in the US has signalled a deregulatory agenda, which includes plans to repeal the Wall Street Reform and Consumer Protection Act of 2010 (also known as the Dodd-Frank Act).

It is not only regulators who continue to place additional demands on the financial services industry in the wake of the financial crisis: the need to rebuild trust has led investors

to call for greater transparency around investments and risk management from those managing their funds. Senior managers at investment firms are, through changes to regulatory requirements and expectations as to firm culture, increasing being seen as individually accountable within their spheres of responsibility. Industry bodies have also noted further moves away from active management into passive strategies, illustrating the ongoing pressure on management costs. This may, in itself, be storing up issues for years to come.

The rise of fintech and other technological developments, including cryptocurrencies, data analytics and automated (or ‘robo’) advice services, is also starting to have an impact on the sector, with asset managers looking to invest in new technologies, seeking strategies to minimise disruption by new entrants, or both. While regulators are open to the development of fintech in the asset management sector, they also want to ensure that consumers do not suffer harm as a consequence of innovations. Regulators across various jurisdictions are working together to develop a global sandbox in which firms can test their new technologies. This continues to be a period of change and uncertainty for the asset management industry, as funds and managers act to comply with regulatory developments and investor requirements, and adapt to the changing geopolitical landscape. Although the challenges of regulatory scrutiny and difficult market conditions remain, a return of risk appetite has also evidenced itself and the global value of assets under management continues to increase year on year. The industry is not in the clear but, prone as it is to innovation and ingenuity, it seems well placed to navigate this challenging and rapidly shifting environment.

The publication of the seventh edition of *The Asset Management Review* is a significant achievement, which would not have been possible without the involvement of the many lawyers and law firms who have contributed their time, knowledge and experience to the book. I would also like to thank the team at Law Business Research for all their efforts in bringing this edition into being.

The world of asset management is increasingly complex, but it is hoped that this edition of *The Asset Management Review* will be a useful and practical companion as we face the challenges and opportunities of the coming year.

Paul Dickson
Slaughter and May
London
August 2018

AUSTRALIA

*Fadi C Khoury, Kon Mellos and Michael Chaaya*¹

I OVERVIEW OF RECENT ACTIVITY

Australia has one of the largest asset management markets in the world, with a savings pool in excess of A\$2 trillion led by a sophisticated superannuation (pension) fund and investment management industry and one of the world's largest sovereign wealth funds: the Future Fund. Annual growth of the investible asset pool is also underpinned by the statutorily mandated employer pension contribution regime (superannuation). Australian and foreign asset management firms have continued to attract investment mandates from the burgeoning Australian superannuation fund pool, including in real estate, infrastructure and private equity opportunities.

The current federal liberal government has maintained an open stance for foreign investors, in particular with substantial investment in Australian real estate, agriculture and infrastructure in recent years.

In recent years, this openness to investment has been supported by further legislative refinements and regulatory policy pronouncements aimed at enhancing the effectiveness of investment structures used across most asset classes. The Australian managed investment trust (MIT) structure has continued to be accepted as an appropriate vehicle for access to Australian investment opportunities in the real estate, infrastructure and private equity sectors. With an MIT, in addition to the statutory capital account treatment of investment realisation gains, eligible investors that are residents in an expanded list of foreign countries may access a concessional withholding tax of 15 per cent on distributions of net rental income and net capital gains made by MITs operating many types of investment strategies. The concessional withholding tax regime is designed to attract investment through an expanded list of local and foreign investment funds, pension funds, sovereign wealth funds and other institutional investors.

The Australian MIT regime has also benefited from the introduction several years ago of the attribution managed investment trust (AMIT) regime. The AMIT regime provides the ability of MITs to be administered with greater flexibility and with the aim of providing a statutory safe harbour curing certain tax uncertainty that traditionally attached to unit trusts. The industry has seen a heavy adoption of the AMIT regime over the past year.

The government has also followed through with other key modernisation measures, with the introduction of draft legislation aimed at facilitating the use of tax-transparent

¹ Fadi C Khoury, Kon Mellos and Michael Chaaya are partners at Corrs Chambers Westgarth.

collective investment vehicles operated as either corporations or limited partnerships, thereby bringing the Australian funds landscape into line with other key markets less familiar with the unit trust structure.

II GENERAL INTRODUCTION TO REGULATORY FRAMEWORK

The Corporations Act 2001 (Cth) (Corporations Act) is the primary legislation governing asset management sector players. The Australian Securities and Investments Commission (ASIC) is the primary securities regulator, and monitors and enforces the Corporations Act and the associated Australian financial services licence (AFSL) regime.

An AFSL is required in order to cover a range of regulated activities, including:

- a* the provision of investment management advice;
- b* the offer of interests in an investment fund;
- c* the provision of custodial and depository services;
- d* prime brokerage and other brokerage;
- e* market-making activity;
- f* underwriting; and
- g* the operation of registered and unregistered investment funds.

Investment funds structured as managed investment schemes generally require registration (as registered managed investment schemes) with ASIC if offered to retail clients, and may register voluntarily in other cases (for example, if offered only to wholesale clients). Wholesale clients comprise certain institutional, sophisticated and professional investors meeting relevant thresholds prescribed by the Corporations Act.

A private placement memorandum, information memorandum or other offering memorandum for an investment fund in which only wholesale clients may invest does not need to be in a prescribed form or include prescribed statements or information, and does not need to be lodged with ASIC. However, various market misconduct requirements under the Corporations Act (aimed at preventing misleading or deceptive conduct in the provision of financial services) will apply to an offering memorandum regardless of whether it needs to be lodged with ASIC.

A holder of an AFSL must:

- a* maintain minimum regulatory capital;
- b* put in place adequate arrangements for the management of conflicts of interest;
- c* have adequate risk management systems;
- d* report significant breaches to ASIC; and
- e* ensure personnel are trained and supervised.

An AFSL holder is subject to an overarching duty to ensure that financial services are provided efficiently, honestly and fairly. In recent years, ASIC surveillance has focused on the approach of organisations to managing ‘conduct risk’, being the risk of inappropriate, unethical or unlawful behaviour on the part of an organisation’s management or employees. This has led to some significant enforcement activity aimed particularly at vertically integrated financial services firms running financial planning and product manufacturing business lines, and was a catalyst in December 2017 for an industry-wide independent inquiry – the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry (Royal Commission) – into the financial services industry.

Subject to some limited exemptions, issuers of interests in, and managers of, investment funds will generally need to hold an AFSL (regardless of whether the investors in the fund are retail clients or wholesale clients).

ASIC has traditionally provided regulated firms from the US, UK, Hong Kong, Singapore and Germany with the ability to apply for access to a statutory passport-like regime covering financial services to wholesale clients in Australia. ASIC has also provided relief for foreign firms that do not carry on business in Australia from the need to hold an AFSL to provide financial services to wholesale clients in Australia. A new limited 'foreign AFS licence' regime is expected to be introduced in 2019, and will provide a modified pathway for access to the Australian wholesale market by foreign regulated firms.

Other regulatory bodies relevant to the asset management sector are as follows:

- a* the Australian Prudential Regulation Authority (APRA), which primarily focuses on the prudential regulation of banks, insurance companies, superannuation funds and, most recently, non-bank lenders;
- b* the Australian Securities Exchange (ASX), which prescribes rules governing the listing of investment funds on the ASX, including listed REITs and exchange traded funds, as well as rules governing the conduct of market operators and brokers;
- c* the Australian Transaction Reports and Analysis Centre, which administers Australia's anti-money laundering and counter-terrorism financing laws, including rules relating to identification of investors in investment funds and counterparties to derivative transactions;
- d* the Foreign Investment Review Board (FIRB), which screens applications for foreign investment into Australia, in particular with respect to investment into residential property, large commercial real estate investments, agricultural investments, infrastructure, or other investments above certain monetary thresholds or that raise national interest considerations. Additional screening requirements apply for investment by foreign government investors (including sovereign wealth funds) and investment funds and other entities in which any foreign government investor has a significant interest;
- e* the Takeovers Panel, which focuses on resolving takeover or corporate control-related disputes arising in relation to listed or other widely held entities; and
- f* the Australian Taxation Office, which is the federal revenue collection agency, and is also charged with regulating the self-managed superannuation fund sector.

III COMMON ASSET MANAGEMENT STRUCTURES

i Unit trusts (managed investment schemes)

The investment fund vehicle most commonly used in Australia is the unit trust. A unit trust is a legal arrangement under which a trustee is bound as a fiduciary to administer the pool of assets on behalf of beneficiaries who hold unitised interests in the pool. Unit trusts are regulated as 'managed investment schemes' under the Corporations Act. Unit trusts are generally required to be registered with ASIC if offered to retail clients (in which case, the trust becomes known as a registered managed investment scheme and its trustee becomes known as the responsible entity of the registered managed investment scheme). Registration is optional for a unit trust that is offered only to wholesale clients.

Unit trusts investing in portfolio interests in financial assets or core real estate will generally have tax-transparency, and distributions will be instead be taxable in the hands

of unitholders (if Australian tax residents) or on a withholding basis (from distributions to non-Australian tax resident unitholders). However, unit trusts that carry on a trading business, or take controlling interests in portfolio entities that carry on a trading business, will generally be taxable at the unit trust level.

Unit trusts that are eligible to meet the criteria for MIT status may attract a concessional taxation profile, including (potentially) a concessional withholding tax rate (15 per cent) on distributions of rental income by real estate-based MITs, and capital account treatment of realisation gains made on investments that are held for at least one year (thereby accessing discounted capital gains tax treatment of those gains in the hands of resident individuals and Australian superannuation funds). Eligibility for MIT status requires, among other things, satisfaction of certain requirements, including a requirement that certain investment management decisions be made within Australia, a widely held requirement (which may potentially be satisfied also if a substantial part of the unitholder base comprises certain types of widely held unitholders, such as pension funds), and an investment strategy that excludes the taking of controlling interests in portfolio entities that carry on a trading business.

Unit trusts may be operated in any manner as determined in the trust deed adopted by the trustee, which may, for example, provide for operation either as an evergreen or closed-end fund.

ii Investment companies

Corporations are not commonly used as investment fund vehicles, given that taxation is levied at the company level.

Draft legislation has recently been introduced to provide the asset management industry with the ability to adopt a corporate collective investment vehicle structure that operates on a tax pass-through basis, subject to operating within the parameters of the legislation.

iii Limited partnerships

There are two types of limited partnerships available under state-based legislation: an incorporated limited partnership and an unincorporated limited partnership.

Unincorporated limited partnerships are rarely used as investment funds, particularly as their limitation of liability regime for limited partners is less favourable than the corresponding regime in relation to incorporated limited partnerships. An incorporated limited partnership is given separate legal personality as a body corporate, and its limited partners have a statutory limitation on liability for the debts of the incorporated limited partnership (provided limited partners do not take part in the management of the incorporated limited partnership or otherwise fall within the statutory safe harbour against such liability). Incorporated limited partnerships are commonly used (along with MIT structures) in the private equity and venture capital asset classes.

Limited partnerships in Australia are taxed at the limited partnership level unless they are registered with the government as venture capital limited partnerships (VCLPs), early stage venture capital limited partnerships (ESVCLPs) or Australian funds of funds (AFOFs), or they are established as venture capital management partnerships that act as general partners of a VCLP, ESVCLP or AFOF. The legislation governing these types of limited partnerships was designed to encourage Australian and foreign investment into the private equity and venture capital asset classes, particularly in relation to early stage and other venture capital investments.

In the case of VCLPs, eligible foreign investors will generally not be subject to withholding tax on gains distributed to them as limited partners.

In the case of ESVCLPs, resident and foreign investors will generally be exempt from any tax on gains distributed to them as limited partners, and certain tax credits may also be available to limited partners.

An AFOF is permitted to invest into VCLPs, ESVCLPs and co-investment opportunities originated by underlying VCLPs and ESVCLPs.

iv Segregated mandates

A substantial part of the institutional investor asset pool is allocated to managers by way of segregated mandates under an investment management agreement arrangement or through a ‘fund of one’ structure (whereby the institutional investor is the sole investor in the fund entity, subject to any carried interest and any investment commitment made by the fund manager or any of its affiliates). A benefit of such arrangements is that the institutional investor may agree a bespoke mandate with the asset manager, including terms as to investment strategy, management fees, performance fees and carried interest terms, matters that require approval by the institutional investor and reporting requirements, as well as leverage the existing custodial arrangements of the investor.

IV MAIN SOURCES OF INVESTMENT

The funds management services industry has continued to perform strongly in recent years. In particular, funds sourced from overseas markets have grown significantly, with a positive impact on industry revenue, which is expected to grow at an annualised 3.7 per cent over the five years to 2018 (to reach A\$7.9 billion). Industry revenue is forecast to grow at an annualised 3.1 per cent to reach A\$9.3 billion over the five years from 2022 to 2023. In the period from 2017 to 2018, assets invested by Australian fund managers on behalf of clients (excluding superannuation funds) are forecast to reach A\$930.9 billion.²

Some drivers of revenue growth include the Australian share market’s performance, the impact of movements of investment markets in driving performance fees, consolidation leading to economies of scale, growing funds under management and increased outsourcing of back-office operations to third parties. Balancing this is some evidence of downward management fee trends caused by increased competition, including from new technology solutions such as robo-advice. Looking ahead, the continuing popularity of alternative investment products and also Australia’s aging population should support further industry revenue growth.

V KEY TRENDS

i Introduction of corporate and limited partnership fund structures

The Treasury Laws Amendment (Corporate Collective Investment Vehicle) Bill 2018 was introduced to enable asset management firms to structure an investment fund as a corporation. Legislation facilitating more widespread use of a limited partnership structure is also proposed (currently, limited partnerships are used only in the private equity and venture capital sectors). The overarching aim of such legislation is to provide a choice of tax-transparent structures

2 IBISWorld, ‘Industry Report K6419a – Funds Management Services in Australia’, October 2017, William McGregor.

(unit trusts, corporations or limited partnerships) but with equivalent governance features. The introduction of these alternative structures reflects industry feedback that corporations and limited partnerships are more familiar legal structures in many markets outside Australia, including across Asia.

The new structures aim to complement other legislation (the Corporations Amendment (Asia Region Funds Passport) Bill 2017) aimed at facilitating the cross-border marketing of similarly regulated fund products across a number of jurisdictions that are signatories to the new Asia Region Funds Passport regime (initially Australia, South Korea, Thailand, New Zealand and Japan).

ii Reform of stapled entity structures

Infrastructure funds and private equity real estate funds commonly adopt stapled fund structures that involve an investor subscribing for interests in a trust (MIT) and either interests in a taxpaying trust or interests (in the form of shares) in an investment company. The interests of each investor in these entities are contractually stapled together in the sense that a dealing in an interest of an investor in one entity requires a corresponding dealing in the interest of the investor in the other entity. Under a typical stapled structure, the MIT would invest in entities that do not carry out a trading business (such as entities holding real estate that is not being developed), and the other entity would invest in trading entities (such as entities that hold real estate that is being developed).

In March 2018, the Treasury announced certain ‘integrity’ measures aimed at minimising use of stapled structures to ‘convert’ what would otherwise be active business income to ‘passive income’. These measures are intended to cover situations where a tax-transparent stapled entity invests in developed real estate and leases that real estate to another stapled entity to carry on a trading business on that real estate. The Treasury announcement expressed concerns that these types of stapled structures are sometimes used in ways to convert what would otherwise be ‘active income’ into ‘passive income’, which in turn has produced a competitive advantage to investors that are not residents in Australia. The integrity measures include an increase in the MIT withholding tax rate on ‘active business income’ from 15 to 30 per cent (subject to potential seven to 15-year transitional measures and exceptions, particularly benefiting infrastructure funds). The above-mentioned announced measures would principally capture stapled investment holding structures as opposed to stapled investment fund structures of the kind described above. The measures regarding stapled structures would generally not apply to stapled investment fund structures that do not involve one stapled fund entity leasing or licensing assets (such as real estate) or lending money to another stapled fund entity.

The announced measures also propose to:

- a* lower the thin capitalisation associate test from 50 to 10 per cent to prevent the use of ‘double gearing’ structures;
- b* limit the withholding tax exemption for foreign pension funds to interest and dividend income derived from portfolio-like interests; and
- c* enshrine in legislation the administrative sovereign immunity tax exemption for non-commercial investments, and limit it to portfolio-like interests of less than 10 per cent and only where the sovereign investor cannot influence key decision-making of the portfolio entity.

Additional measures are also to be introduced for MITs that invest in agricultural land.

iii Royal Commission inquiry into the financial services sector

In December 2017, the federal government initiated an independent inquiry into the financial services sector: the Royal Commission. The inquiry has a broad scope of review and (among other things) has focused on a review of vertically integrated financial services firms that provide financial advisory services and also issue their own financial products to their financial advisory services clients. This follows on from examples of misleading selling practices in relation to in-house manufactured financial products. The inquiry is expected to lead to increased enforcement activity by ASIC and potential legislation restricting the vertically integrated business model.

iv Australian financial services licensing of foreign financial services providers

In June 2018, ASIC commenced a consultation process regarding the proposed adoption of a mandatory 'foreign AFSL' regime for offshore asset managers that are interested in advisory or asset management relationships with wholesale clients in Australia. The proposal is that the foreign AFS regime will mirror the existing AFSL regime, subject to the relaxation of a number of regulations where the foreign financial services provider is otherwise regulated under a sufficiently equivalent foreign regulatory regime.

Expected to be introduced on or after 1 July 2019, the foreign AFSL regime will replace the passport regime currently relied on by foreign financial services providers from a number of jurisdictions with regulatory regimes that are viewed as sufficiently equivalent to the Australian regime. Under existing law, foreign financial services providers that are regulated by their equivalent securities regulator in the US, UK, Hong Kong, Singapore or Germany may access relief from the need to hold an AFSL to provide financial services to wholesale clients in Australia. The relief is provided by way of the filing of certain documents with ASIC.

v New reporting measures for credit funds

Through recently introduced legislation, an expanded range of lenders (potentially covering debt funds) with more than A\$50 million in loan receivables are subject to new obligations to report on their lending activities to APRA. The aim is to enable APRA to capture and monitor some of the metrics otherwise captured from traditional bank lenders.

vi Strengthening the dispute resolution body

From November 2018, the Australian Financial Complaints Authority (AFCA) will replace the Credit and Investments Ombudsman, Financial Ombudsman Service and Superannuation Complaints Tribunal. AFCA will have a higher monetary limit (A\$1 million) and a higher compensation cap (A\$500,000) for most non-superannuation disputes, and unlimited monetary jurisdiction for superannuation disputes.

VI SECTORAL REGULATION

i Insurance

The insurance industry is regulated by (APRA) and ASIC. As the prudential regulator, APRA sets out both standards and practice guides for the life and general insurance industry. ASIC focuses on consumer protection.

The rules regarding the investment of insurance premiums for life insurance are set out in the Life Insurance Act 1995 (Cth). The Insurance Act 1973 (Cth) sets out some rules regarding the eligible assets that are required to be held by general insurers; however, there are no restrictions on investments that can be held by insurance companies other than the trust account requirements under the Corporations Act. APRA has issued a number of prudential standards that regulate the activities of both life insurers and general insurers from a prudential perspective.

There are a number of emerging technological trends such as the rise of artificial intelligence and B2B insurtech that will likely have a significant impact on general insurance and life insurance in Australia.³ Although the US is pioneering the development of insurtech, with US\$1.7 billion having already been invested, Australia is seen as a fertile testing ground to trial these customer-focused technologies.⁴

ii Pensions

Pensions are referred to as ‘superannuation’ in Australia. APRA has the primary regulatory responsibility for superannuation funds under the Superannuation Industry (Supervision) Act 1993 (Cth). However, ASIC also plays a role in superannuation, as the trustee of any superannuation fund is required to hold an Australian financial services licence and be subject to the licensing, conduct and disclosure rules under Chapter 7 of the Corporations Act (which are supervised by ASIC).

As at 30 June 2017, Australia’s total superannuation industry assets were valued at A\$2.5 trillion.⁵ These assets are held by APRA regulated superannuation entities, self-managed superannuation funds, exempt public sector superannuation schemes and life office statutory funds. The sheer size of this asset pool is attributed to the compulsory superannuation guarantee scheme, which requires employers to currently contribute 9.5 per cent of their employees’ wages and salaries to a designated superannuation fund.

In terms of recent reforms, the 2018–19 Federal Budget placed great emphasis on a ‘protecting your super’ package, which limits the fees charged by funds, requires insurance to be opt-in for certain individuals and facilitates the consolidation of low balance super accounts. Subject to legislation being passed by the Federal Parliament, these reforms will commence on 1 July 2019.

Under the Federal Budget, the government has also announced a new retirement income framework that covers a retirement covenant and standardised product disclosure metrics. APRA and ASIC will also receive increased funding to facilitate their involvement in the current Royal Commission.

A recent Productivity Commission Report examined whether default super fund allocation would improve outcomes for members. It recommended that new entrants to the workforce should be provided with simple information on the features of 10 ‘best in show’ super funds (as selected by an independent expert panel) but then ultimately be able to choose any fund.

3 <https://assets.kpmg.com/content/dam/kpmg/au/pdf/2017/general-insurance-industry-review-2017.pdf>, pp. 10 and 13.

4 <https://assets.kpmg.com/content/dam/kpmg/au/pdf/2017/general-insurance-industry-review-2017.pdf>, p. 14; <https://www2.deloitte.com/au/en/pages/financial-services/articles/insurance-industry-outlook-2018.html#f-2>.

5 <https://www.apra.gov.au/sites/default/files/2018-ASB-201706.pdf>, p. 1.

iii Real property

Australian real estate investment funds continue to attract substantial inflows from Australia and foreign investors.

As discussed above, one of the key reforms affecting the real estate and infrastructure investor sector is the proposed changes in the tax treatment of stapled investment structures. These reforms will significantly impact real estate and infrastructure investment structures, particularly where those investments comprise investment in real estate and in a portfolio entity that carries on a business on the real estate.

As also discussed above, Australia's foreign investment laws require approval by FIRB of certain acquisitions of interests in Australian real estate, depending on the nature and size of the investment. A stricter regime applies if the acquisition is by a 'foreign government investor' (which broadly captures entities including funds) in which a foreign government or foreign government body has an interest of 20 per cent or more.

Australia's foreign investment laws also allow investors and investment funds to apply for 'exemption certificates' in certain circumstances (which apply as a form of pre-approval by FIRB of certain investments by the applicant that meet some common criteria). The FIRB has recently updated its policy with the aim of providing clarity to investors and investment funds seeking to apply for 'exemption certificates'. Exemption certificates are increasingly sought by investors and investment funds that wish to obtain pre-approval by FIRB of a future programme of acquisitions, particularly given the time and costs that would otherwise be involved in having to make individual applications for each proposed investment. An exemption certificate generally applies for a prescribed period (commonly one year), and covers acquisitions that meet certain pre-approved criteria and have an acquisition value below the prescribed individual acquisition amounts (subject to an aggregate overall acquisition value).

A newly introduced condition for FIRB approval in relation to certain types of acquisitions (primarily real estate) is that the applicant demonstrate that the relevant vendor has undertaken a transparent advertising process to market the investment for sale in the Australian market prior to investment by the relevant foreign person.

iv Hedge funds

The Australian market has seen a heightened level of market activity by activist hedge funds. This has included actions by certain hedge funds calling for shareholder meetings to agitate for a change in the board or overall strategy of a portfolio company.

A high-profile foreign hedge fund (with an investment strategy that included short-selling) attracted considerable attention in 2018 following publication of its in-house research asserting that the value of a particular ASX-listed company (which carried on an investment management business) was less than half the value reported by the company to the market. The company's share price experienced a dramatic decline. Some market commentators have called for a review of the application of Australian laws (including market misconduct rules and AFSL laws) in relation to foreign short sellers making announcements in the Australian market.

In recent years, hedge funds have had to prepare for the commencement of APRA prudential requirements for margining and risk mitigation of non-centrally cleared derivatives (APRA Prudential Standard CPS 226), which is one of the latest outcomes of the G20's response to the financial crisis. This has involved completion of self-disclosure documents

and entry into new credit support documents for hedge funds that trade with a bank or other prudentially regulated entity to which the Australian margin rules apply, or any other financial institution to which any foreign margin rules apply.

v Private equity

As discussed above, venture capital funds in Australia are commonly structured as closed-end incorporated limited partnerships that are registered with the government as VCLPs or ESVCLPs. However, given the legislative restrictions that apply to the investment activities of VCLPs and ESVCLPs (most notably, the restriction on investing in a portfolio entity that has assets totalling more than A\$250 million), venture capital fund structures may include, or allow the establishment of, alternative investment vehicles to make investments that a VCLP is restricted from making. The most common alternative investment vehicle structure is parallel MITs that co-invest in the investment opportunity that falls outside the permitted investment activities of the VCLP. The alternative investment vehicles may be used to invest in more than one portfolio entity.

Private equity funds in Australia are most commonly structured as parallel closed-end MITs. The parallel fund structure gives cornerstone investors, and other investors that are making large commitments to the fund, the opportunity to each invest separately in a parallel fund entity, and for all other investors to invest in a pooled parallel fund entity. The opportunity for a larger investor to invest separately in a parallel fund entity that qualifies as an MIT affords an investor that is a superannuation fund, pension fund or other widely held fund greater control in satisfying the ongoing widely held test that applies to the MIT.

Some common variations to the parallel fund structure for private equity funds include the use of a foreign parallel fund entity for some or all of the foreign investors, and the use of a parallel VCLP (together with alternative investment vehicles as discussed above) for some or all of the domestic superannuation fund investors and some or all of the foreign investors.

Access to co-investment opportunities (on a no management fee and no carried interest basis) remains a key focus of many larger domestic institutional investors. However, the use of overflow or co-investment funds by domestic private equity funds as means of co-investment access by investors remains less common than in other developed markets. The more common approach is for co-investment opportunities to be presented on a case-by-case basis to one or more of the larger investors, and for the co-investments to be undertaken directly by those investors.

Management fees for domestic private equity funds still tend to be set at 2 per cent per annum of committed capital (dropping down to invested capital after the investment period) but with the possibility, in some cases, of fee rebates under side letters for cornerstone or larger investors. Carried interest has generally remained at a rate of 20 per cent of distributed profits (on a whole-of-fund basis) subject to a preferred return of 8 per cent per annum to investors and a carried interest catch-up (at a rate ranging from 50 to 100 per cent). Director fees, transaction fees and break-up fees are commonly offset at a rate of 100 per cent against management fees.

Private equity funds in Australia largely adopt the best practice reporting and valuation guidelines formulated by their industry body, the Australian Private Equity and Venture Capital Association, and are largely aligned with the private equity principles formulated by the Institutional Limited Partners Association. As the domestic private equity funds industry

continues to attract significant investment from foreign investors, we also expect to see the continued alignment of domestic private equity funds terms with those in other developed private equity markets.

VII TAX LAW

As discussed above, the tax profile of funds, managers and investors is driven by the particular vehicle used and the particular investment activities undertaken by it. Overall, government has maintained an investor and manager-friendly policy stance, with further legislative refinements aimed at facilitating internationally recognisable fund structures, including the proposed new reforms that will enable broader use of corporations and limited partnerships as collective investment vehicles.

Again as above, one recent area of Treasury focus has been in relation to the use of stapled investment holding structures, which are commonly used by domestic and foreign investors, particularly to access real estate and infrastructure investment opportunities. Existing stapled structures may access the transitional arrangements, which can apply for seven to 15 years; however, the new integrity measures will need to be taken into account in the design of new investment holding vehicles.

VIII OUTLOOK

Further M&A activity is expected in Australia, as intense government and regulatory focus on vertically integrated financial services firms is leading to some such firms demerging their financial product issuance businesses from their financial planning and investment advisory businesses.

The introduction of alternative collective investment structures, coupled with the Asia Region Funds Passport, should assist Australian asset managers to more effectively access foreign investor markets.

Australian managers should continue to be supported by the reforms of several years ago, and since adopted in practice, under the investment manager regime, which removes some traditional tax uncertainty associated with foreign funds engaging with Australian managers.

In terms of foreign asset manager access to the Australian investor market, the new foreign AFS licence regime will involve an upfront cost in the associated application process. This should, however, provide certainty for managers in terms of a clear pathway for access to the Australian market, as well as enhance Australian investor confidence associated with engaging with foreign managers.

The industry is expecting sustained foreign investor interest in Australian real estate, agriculture and infrastructure investment exposure. MIT structures are becoming understood by more and more well-known large foreign investors, and accepted as the gateway necessary to access a concessional withholding tax profile.

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