Australian Private Equity &
Venture Capital Association Limited

4 September 2015

Mr Maan Beydoun
Senior Specialist
Investment Managers and Superannuation
Australian Securities and Investments Commission
Level 5, 100 Market Street
Sydney NSW 2000

Email: feeandcostdisclosure@asic.gov.au

Dear Maan,

AVCAL submission on Draft RG 97: Disclosing fees and costs in PDSs and periodic statements

The Australian Private Equity and Venture Capital Association (AVCAL) appreciates ASIC's invitation to comment on the proposed revisions to Regulatory Guide 97 (RG 97), as set out in the latest draft.

AVCAL represents the venture capital (VC) and private equity (PE) industry in Australia, which has a combined total of over $24 billion in funds under management for domestic and offshore investors. Australian PE and VC firms invest in businesses on behalf of their fund investors, also known as limited partners (LPs). Superannuation and managed investment product issuers form a critical part of the LP base, and are also members of AVCAL.

AVCAL supports ASIC's objective of greater consistency in fee and cost disclosure across the superannuation and managed investment sectors.

While the latest draft RG 97 is a step in this direction, in AVCAL's view further improvements in the guidance will greatly help improve consistency and reduce uncertainty in implementation, and consequently improve the usefulness of fee and cost disclosures for end-users. In AVCAL's view, these improvements can be achieved by:

- The development of industry standards, in collaboration with ASIC, to provide clearer guidance on how PE/VC fees can be meaningfully reported by superannuation investors to comply with ASIC expectations.

- A clearer and simpler definition of what constitutes an interposed vehicle, with fair and consistent fee disclosure requirements for funds (or fund-of-funds) that engage in similar investment activities, regardless of whether the vehicle is listed or unlisted.

- Clarification of new "indirect fee" concept.

AVCAL's recommendations are set out in further detail in the attached submission. If you would like to discuss any aspect of this submission, please do not hesitate to contact me or Dr Kar Mei Tang on (02) 8243 7000.

Yours sincerely

Yasser El-Ansary
Chief Executive

AVCAL SUBMISSION

1. Need for the development of industry standards to provide clearer guidance on how PE/VC fees can be meaningfully estimated and reported by superannuation investors to comply with ASIC expectations

Translating PE investment fees to annual Indirect Cost Ratio (ICR) calculations can be problematic, and efforts to do so raise a number of immediate implementation issues.

Aggregated ICR metrics need to be interpreted cautiously when aggregating fees across a diversified portfolio with a wide range of fee structures for different assets. Reducing a large range of very different (and sometimes complex) fee structures into an aggregated fee metric on product dashboards means that the interpretation of that metric should be treated cautiously.

In general, standard PE/VC fee structures pose several issues for aggregated ICR calculations:

- **Year-on-year estimations of PE/VC fee metrics can be very volatile.** In particular, fee structures which are unevenly spread out over time such as those used in the PE and VC industry can be difficult to translate directly to “one size fits all” fee metrics such as the ICR without creating potentially misleading conclusions for users not familiar with how such fee structures work. **Attachment 1** sets out some examples to demonstrate how inconsistent interpretations may arise in practice. The true cost of the investment can only be accurately reported when considering the PE/VC fund’s “whole of life” fees. This may not always be well understood by users who rely on short term ICR estimates. For shorter horizons, a more meaningful metric might be an average of the medium-term fees and costs payable over that period, to smooth out short term volatility in fees from year to year.
- **Different asset classes can have different fee bases, which is not always captured well by the ICR.** For example, in listed equities the denominator of the fee metric will typically just be the current market value of the initial “one off” investment. However, in PE/VC the denominator will also be dependent on capital calls from, and distributions to, investors over the period in question.
- **The drafting of the principles underpinning the ICR, as set out in CO 14/1252, can give rise to uncertainty when applied to PE and VC investments.** CO 14/1252 4(f)(3)(a) states that indirect costs should include “the amount that is the difference between the underlying return and the actual return, where the return on the product or option would have been greater if the responsible entity or trustee had received or paid, as applicable, the underlying return rather than the actual return on the relevant financial product over the relevant period”. If referring to the counterfactual if the fee had not been incurred, this principle is difficult to apply to “buy-and-improve” and “turnaround” strategies used in PE investments, because the “underlying return” of a PE investment would be very different if the PE investment had not taken place. Alternatively, if this is simply referring to the difference between the gross and net returns after fees then an appropriate clarification would be helpful.

AVCAL is of the view that the ICR needs to be representative of the true cost of investment and to usefully help in informed decision making by end-users.

Feedback from superannuation funds indicates an appetite for industry standards to provide guidance on translating PE/VC fee components into their regulatory fee reporting.

AVCAL PE and VC members are already required to follow the AVCAL Reporting Guidelines, which include detailed guidance and templates on the reporting of fees and costs charged to investors.

These can be complemented by a set of industry standards to promote consistent and accepted best practice in super funds’ fee reporting with respect to their PE/VC investments. A benefit of having industry-led standards for superannuation funds investing in PE/VC is that the standards can be relatively nimble in providing updated guidance on new issues – some of which may be very specific to the particular asset class – that may arise over time. For example, there are currently different practices among superannuation investors on how some elements of investment fees and costs are treated within the ICR. These include, for example, the treatment of:

- Items which may or may not constitute a cost (for example, there are different views on whether taxes and interest payments are costs that should be included within the ICR);
- Backdated management fees;
- Equalisation interest (paid by later investors at the subsequent close of a PE fund to the earlier investors in the fund, to compensate the earlier investors for their earlier contribution to the fund); and
- Clawbacks (the obligation of the PE fund manager to return previously received performance fees due to subsequent losses).

As the industry body, AVCAL is ready to work with ASIC and our members (which comprise both PE/VC fund managers and superannuation investors in these funds) to develop appropriate industry standards and working examples to promote consistent reporting of PE/VC fees and costs by both fund managers and superannuation investors.

As a starting point, this could begin with improved guidance on how to report PE/VC fees. For example, it may be recommended that estimated PE/VC fees in PDSs should be reported based on (say) 3 and 5 year fee averages in addition to the annual MER/ICR, so as to remove the short term “noise” which can arise in long-term fee structures.

The development of industry standards, in collaboration with ASIC, will help provide clearer guidance on how PE/VC fees can be meaningfully estimated and reported by superannuation investors to comply with ASIC expectations.

2. The definition of 101B Interposed Vehicle is needs to be clarified and consistently applied across listed and unlisted vehicles

The proposed definition of a 101B Interposed Vehicle in CO 14/1252 is complex and confusing, and should to be reviewed for clarity and consistency.

In the proposed definition, clauses 4(a) and (b) on pp.4-5 of the draft class order appear to ask essentially the same question in a different way, with the key point of differentiation being that 4(a) applies to listed vehicles while 4(b) applies to unlisted vehicles. The reason for this differentiation is unclear. They key implication here is that listed and unlisted vehicles are treated differently for fee reporting purposes, to the detriment of unlisted investors and unlisted fund managers. We believe this is a market wide issue with obvious issues in the property industry.

The current conditions and differentiated treatment for listed and unlisted vehicles under these clauses are unnecessarily complex, and could foreseeably create a regulatory-driven bias towards listed vehicles in order to take advantage of lower reported fees (even if the underlying investment opportunity is exactly the same, and the use of unlisted vehicles may be more aligned to members’ economic interests).

It is also unclear how investments in PE/VC funds would be regarded in this matter. Sections 1 and 4(b)(ii) appear to suggest that they will be regarded interposed vehicles, but it is not clear if this is the intent. Further clarity through examples in this regard would be helpful.

In AVCAL's view, there appears no clear or compelling reason for the definition of a 101B Interposed Vehicle to differentiate between listed and unlisted vehicles that engage in substantially the same activities. AVCAL recommends a clearer and simpler definition of what constitutes an interposed vehicle, with fair and consistent fee disclosure requirements for listed and unlisted funds (or fund-of-funds) that engage in similar investment activities.

AVCAL also recommends the inclusion of some clear working examples on how the definition of 101B Interposed Vehicle applies to PE/VC funds and PE/VC fund-of-funds, whether listed or unlisted.

The following amendment and additional example in RG 97 are proposed to provide more clarity:

Proposed amendment to RG 000.51: "For example, if the PDS … describes the asset allocation for the investment option (eg a balanced option or a product) to include an investment in a trust, body or partnership of a particular type that invests less than 70% in relevant securities (e.g. a private equity fund [This is because the businesses which it has bought and now owns and operates have conferred control to the private equity fund so are not recognised as relevant securities]) then these trusts, bodies or partnerships would not be interposed vehicles and the costs of investing in these vehicles that are attributable to the super fund or managed investment product would not need to be considered when calculating the super funds or managed investment products indirect costs."

Proposed new example following RG 000.51: "For example, if the PDS … describes the asset allocation for the investment option (eg a balanced option or a product) to include an investment in a trust, body or partnership of a particular type that invests more than 70% in relevant securities (eg hedge funds or a private equity fund-of-fund [which does not have control over the underlying investments or the underlying return from those investments]) then these trusts, bodies or partnerships would be interposed vehicles and the costs of investing in these vehicles that are attributable to the super fund or managed investment product would need to be considered when calculating the super funds or managed investment products indirect costs."

3. Clarification of new "indirect fee" concept

The draft RG97 includes a new concept called "indirect fee" in section 000.169 which states that "only an amount indirectly charged to members through interposed entities will be classified as an indirect cost, while any costs deducted from the superannuation fund that are fees and costs should be identified as indirect fees".

In the example provided, it says that where an issuer charges a percentage-based investment fee this should be included in the "indirect fee" but not "indirect cost". This example is confusing as such investment fees charged by intermediaries have typically been regarded as indirect costs.

AVCAL recommends further clarification on what the "indirect fee" is intended to cover, and how this is different from an indirect cost, with relevant examples where necessary.

****

ATTACHMENT 1

PE AND VC FEES: ISSUES AND CHALLENGES IN CURRENT REGULATORY FEE REPORTING METHODS

1. The PE and VC investment model

PE and VC firms raise their funds by securing commitments from investors, which are pledges of capital to the PE or VC fund. PE/VC funds are *closed-end* with a life of typically 10 years, and LPs will normally remain committed for the entire life of the fund.

The GPs allocate the fund's capital across a number of investments that fit the fund's investment mandate or focus. These investments are typically long-term with average holding periods of five to seven years.

Investment life cycle

Instead of a "one-off" drawdown at the point of initial commitment, PE and VC capital is gradually drawn down from investors on a "just in time" basis when investments are identified and made during the investment phase (typically during the first five years). After an average holding period of around five years for each investment, PE and VC funds exit their investments to realise a return for investors.

2. How PE and VC fees are structured

Fee structures and fee reporting are agreed on between the investors and the PE or VC fund at the time an investor makes a commitment to a PE or VC fund. The fund's constituent documents and the management agreement between both parties stipulates how fees are to be charged and applied, and how they are to be reported to the investor. In the fund's quarterly reports to its investors, the fund reports the amounts drawn down and invested so far, and the cashflows in and out of the fund. Fees are typically broken down in detail to indicate how much was paid in management and performance fees, and any offsets against those fees.

Some important characteristics of PE and VC fee structures are highlighted below.

A. Management Fees are fixed over the investment period, then progressively decline for the remaining term of the fund

- Typically, management fees are set at between 1.5-2% of the investor's total commitment to the fund over the investment period – usually the first five years – of the fund. This is used to pay staff salaries, market research, overheads and other costs of running the fund.
- After the investment phase of the fund ends, the fund enters a fee step-down phase where the base fee progressively reduces over the remaining years of the fund's life. For example, the fund could charge a management fee of 2% on invested capital during the first five years, and 1.75% thereafter on invested capital until that amount reduces to zero. The investor actually pays less management fees as the fund matures (even if the market value of the portfolio is rising). This feature is included in the fee structure as it recognises that the fund manager's workload typically reduces as the fund begins exiting investments to realise returns for its investors.
- As a result, net management fees paid by the investor are lower than the 1.5-2% initial fixed rate when averaged out over the fund's life. In practice, total management fees generally add up to less than 1% p.a. of the PE fund's size when averaged out over 10 years.
- This fixed base fee structure also means that the management fee does not vary based on increases/decreases in the investment's market value (the denominator in the MER/ICR calculation),

compared to an asset-based fee structure where the manager would obtain higher management fees when overall market valuations go up (even though the extent of work done by the manager does not vary in any way).

B. Management fees are distributed back to investors before PE and VC managers receive performance fees

- Performance fees are typically set at 20% of the fund's gains, and are only triggered if the fund meets its "preferred return", i.e. a predetermined rate of return above the market benchmark (usually around 8%).
- Before the managers can receive a performance fee, they typically have to first distribute sufficient returns back to investors to repay the management fees plus the preferred return. In other words, the PE management fee is usually not a permanent expense which reduces the investors' returns, but rather an advance to the manager which must be repaid before any performance fees flow through to the manager.
- Performance fees in Australian funds are typically calculated on a whole-of-fund basis rather than deal-by-deal basis, i.e. they are only triggered if the net realised proceeds from all invested capital in the fund exceed the preferred rate of return.
- These types of performance fee structures help align the interests of fund managers and investors with the objective of achieving the best possible net returns from invested capital.

3. What PE and VC fee structures mean for MER/ICR calculations

A diversified portfolio will have a diverse range of fee structures across different asset classes. Reducing a large number of complex fee structures into the single headline fee metric reported on product dashboards means that interpretation of that metric should be treated cautiously.

In particular, nonlinear fee structures such as those used in the PE and VC industry are difficult to translate accurately to standard fee metrics such as the Indirect Cost Ratio (ICR) or Management Expense Ratio (MER).

This is because:

- The “drawdown” investment style of PE and VC investing means that denominator of the MER/ICR calculation is different to that of, say, equities or bond mandates which generally track the value of a “one-off” commitment over time; and
- Extreme variability in the management fees over time, coupled with the lumpiness of performance fees, gives rise to volatile short- and medium-term fee metrics which do not deliver to the end-user a consistent and informed picture of the true costs and net performance of the investments.
- There is no standard industry practice among superannuation investors on how some elements of fees (some of which may also be applicable to other asset classes) should be treated within the ICR. For example, there is no clear guidance on the appropriate classification of:
    - Items which may or may not constitute a cost (for example, there are different views on whether taxes and interest payments are costs that should be included within the ICR);
    - Backdated management fees;
    - Equalisation interest (paid by later investors at the subsequent close of a PE fund to the earlier investors in the fund, to compensate the earlier investors for their earlier contribution to the fund); and

- Clawbacks (the obligation of the PE fund manager to return previously received performance fees due to subsequent losses). These result in lower lifetime fees paid to the fund manager, but there may be differing views on the usefulness of regularly reporting adjusted historical fees to members.

Consequently, the current year-by-year estimation of PE/VC fee metrics will result in highly volatile fluctuations in PE/VC fee metrics which may not be well understood, and hence impede the effectiveness of decision making by users relying on such information.

Comparability with the fees and costs across asset classes requires the appropriate calculation of the true cost of PE/VC investment. This can only be made when considering the PE/VC fund's "whole of life" fees (or, alternatively, a reasonable estimation or averaging method over a medium-term horizon).

Below are two examples of how existing fee disclosures can be potentially distortionary and misleading when evaluating the fees for different asset classes.

Example 1: Existing fee disclosures can distort the true cost of investments

It can be seen that PE and VC fees are difficult to translate accurately to standard fee metrics such as the Indirect Cost Ratio or Management Expense Ratio, due to their nonlinear nature over the life of the fund.

The typical cashflow pattern for investors in a PE fund is illustrated in **Figure 1**. As can be seen, the management and performance fees can fluctuate significantly over the life of the fund. **Figure 2** illustrates an example of the annual fees attributable to the fund manager, indicating:

(i) The highly nonlinear nature of PE fee structures, with declining management fees over time and "lumpy" payments towards the end of the fund's life when performance fees are paid out;

(ii) The resulting impact on annual MER/ICR calculations over the fund's lifetime; and

(iii) The significant variance between the annual MER/ICR calculations and the true annual fee averaged out over the fund's lifetime (in this example, resulting in average total management and performance fees of 1.6% p.a. over the ten years).

Figure 1: PE fund cashflows over 10 years

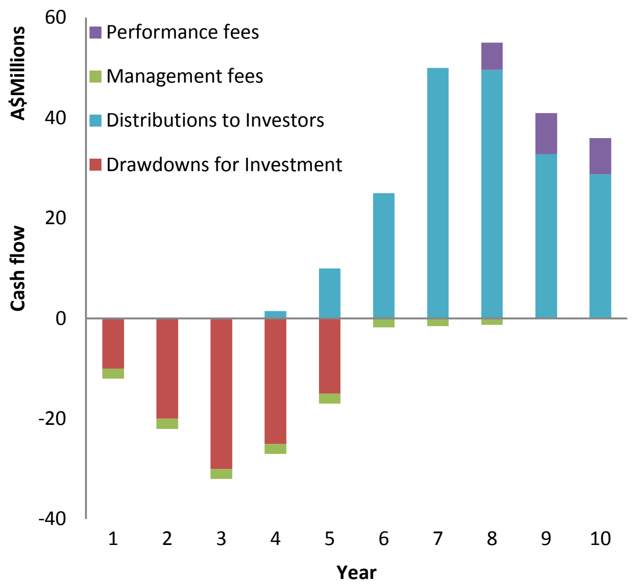
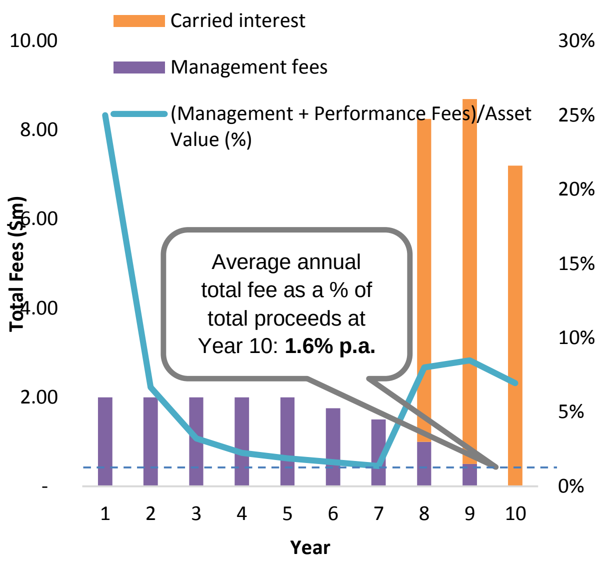


Figure 2: PE fees paid annually



Assumes:

- 2% management fee on committed capital of $100m during the first 5 years, and stepping down by 0.25% every year thereafter
- 20% performance fee after 8% preferred return is achieved
- 2.0x return on committed capital after 10 years
- No fee rebates or offsets, no co-investment structures

Example 2: Need for consistency in reporting fees for listed vs unlisted investments

RG97 currently provides several examples of where fees need to be reported in relation to investments through interposed vehicles.

However, there is still insufficient consistency in the guidance, which potentially creates unintended incentives for the creation of new “non-interposed” structures that will allow investors to report lower fees and costs, for essentially the same investment they would have otherwise made (at probably lower real cost) through alternative structures.

For example, Examples 3 and 9 in the current draft RG97 state that AREITS are not interposed vehicles when invested as part of, say, tracking the ASX200 index, but may be interposed vehicles if “the listed vehicles are not the end investment but the means by which the benefit of the investment is obtained”.

This provides an incentive for the migration to listed vehicles even if the underlying investment opportunity is exactly the same as that of an unlisted vehicle (or, for argument’s sake, as part of an index of unlisted assets). Compounding the issue is the fact that listed investments have a number of unreported fees embedded in the investment, such as company directors’ fees which are not required to be reported for listed investments, but which are reported by private equity managers acting as directors in their unlisted investments.

To avoid regulatory arbitrage by driving market participants to use listed structures instead of more cost-effective unlisted structures, fee metrics need to be consistently applied to investments made through listed and unlisted vehicles. Like-for-like fees and costs which are required to be disclosed for unlisted investments should be similarly disclosed for listed investments to allow valid comparison of the true cost of investment.

4. Suggested next steps

- Regulatory focus needs to be given as much to raising member awareness of the impact of asset allocations on net retirement returns, as to raising awareness of the potential impact of fees on net returns.
- To be comparable, aggregated fee metrics need to be applied consistently across asset classes, listed and unlisted vehicles, and across funds. Annual MER/ICR calculations can lead to inconsistent comparisons across different asset classes: for example, in listed equities the denominator of the fee metric will fluctuate with the market value of the initial "one off" investment, while in PE/VC the denominator will fluctuate due to both market value as well as the drawdowns and distributions back to investors over the period in question. Consequently, it would be worthwhile considering reporting (say) 3 and 5 year fee averages in addition to the annual MER/ICR, so as to remove the short term "noise" which can arise in different fee structures.
- Regulatory fee disclosures should not penalise superannuation investment in asset classes with "lumpy" fee structures over time.
- Feedback indicates an appetite for clearer industry guidance to promote fee reporting consistency for superannuation investors in PE and VC funds. As the industry body AVCAL is ready to work with its members (both fund managers and investors, including superannuation funds) and the regulators to develop and promulgate appropriate industry standards and guidance to promote such consistency and certainty for investors and users of aggregated fee metrics.

****