Private credit funds – Compliance issues informing ASIC's actions

The compliance issues summarised in Table 1.1 underscore the need for industry action to enhance practices in Australia's private credit sector and build preparedness for a potential crisis in a market stress scenario.

ASIC views Table 1.1 as relevant for all types of private capital funds to consider, having regard to the nature of the fund's underlying assets. This table is an excerpt from pages 23-25 of ASIC's Advancing Australia's evolving capital markets: Discussion paper response report.

Table 1.1: Private credit funds – Compliance issues informing ASIC's actions

Issue	Why it matters	Risks	References
1. Transparency (investment information and reporting)	**Fund transparency creates a better market by:** › supporting informed decision making including to help investors understand strategies and risks › informing market pricing and valuation › building trust and accountability, and › protecting against hidden risks or misconduct.	**Transparency gaps in:** › investment strategy, portfolio description and risk exposure › skills and experience of fund operator leadership › valuation policies and processes › impairments, and › marketing and disclosure documents, including investment performance and risk exposure (including to avoid a mismatch in risk being taken on by investors).	› PC report: definitions and use of key terms and investment reporting › Surveillance report: Fund disclosures and transparency.
2. Marketing and distribution practices	**Distribution is critical. Products should be:** › clearly explained for investors and their advisers › balanced and accurate in referencing research houses and credit ratings › appropriately targeted and distributed to suitable investors, and › if wholesale funds only, distributed to wholesale clients only.	**Aggressive marketing and poorly explained products:** › increase exposure and liquidity risk › lead to inappropriate targeting (suitability risk) › can lead to an unanticipated inability by investors to exit a position (liquidity and suitability risk), and › result in poorer wholesale client classification procedures.	› Surveillance report: Marketing and distribution.
3. Treatment of fees	**Fee structures impact investor returns**. They: › can favour managers and reduce returns. **Clear, accurate and effective fee disclosure should:** › help investors better understand what they are paying for › allow comparisons between funds, and › aid informed decision-making.	**Fee disclosure can be poor, misleading or have omissions.** They can be complex and/or unfair, resulting in: › poor understanding and ability to compare fees and costs › investors exposed to risk/return mismatch › misleading disclosure on loan related fees, and › unfair investor treatment regarding loan-related fees paid to managers.	› PC report: Remuneration and fees › Surveillance report: Fee and income transparency section.
4. Management of conflicts of interest	**Conflicts of interest can:** › arise between REs or trustees, managers and investors, or among investor groups, and › impact market efficiency and investor fairness.	› Poorly managed conflicts of interest are a driver of potential misconduct and unfair treatment of investors, including arising from related party transactions, managing conflicting interests across different funds, managing different classes of assets in the same entity (e.g. debt and equity) and fee and distribution arrangements.	› PC report: Related party transactions and governance › Surveillance report: Governance and conflict management.
5. Governance (including independent or active trustees and audit)	**Transparency and safety involve:** › strong and effective fund governance, including the appointment of an independent trustee, and quality of audit, promotes greater transparency and accountability and ultimately safeguards the interests of fund members.	**Mixed governance practices,** including a lack of independent or active oversight where: › the RE, trustee and investment manager are part of the same group › an independent trustee is used but is mostly inactive › the trustee is an appointed authorised representative of a third-party licensee; and › poor quality of audit.	› PC report: Governance and conflict management › Surveillance report: Governance and conflict management.
6. Valuation practices	**Investors rely on fair valuations to assess performance and make informed investment choices. Valuation inconsistencies and errors can harm investors and market integrity.** Valuations drive transaction prices, and entry and exit prices, so accuracy is essential for fairness; they impact management and performance fees.	**Heightened valuation risk includes arising from:** › inconsistent use and transparency of methodologies › a lack of market proxy valuations › insufficient frequency, timeliness and independence of valuations (including on impairments), and › subjective judgements.	› PC report: Valuations › Surveillance report: Valuation practices › Market report: Enduring challenge – Valuations › Data report – (references to valuations) › REP 816 Accounting for your super.
7. Liquidity risk management practices	**Good liquidity risk management and effective disclosure help:** › align the operation and strategy of a fund with investor expectations › avoid liquidity mismatches › support fair treatment of all investors, and › promote confidence in the fund and the broader financial system.	**Key challenges include:** › liquidity mismatch for open-ended private credit funds › poor disclosure to investors about the ability to redeem in times of market stress, and › the potential for fire-sale dynamics.	› PC report: Issues for ASIC consideration – liquidity › Surveillance report: Liquidity management practices.
8. Credit risk management practices (including arrears, defaults, impairments losses)	**Credit risk management is fundamental to protecting investors' capital:** › Private credit funds tend to lend to borrowers with higher risk profiles, and where the underlying assets have limited liquidity › Effective credit assessment, monitoring and diversification reduces defaults and impairments and identifies potential losses earlier, and › Supports accurate valuations, stable returns, and overall fund resilience.	**Illiquid assets** that carry a risk of default and impairment by private credit funds require robust credit risk management to ensure appropriate credit investments are selected, default and impairment events are managed, and any investor losses are minimised.	› Surveillance report: Credit risk management practices.