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Background

By way of background SQM Research (SQM) is a fund researcher, issuing fund ratings under its Australian Financial Services License. SQM is also an investment data supplier covering all asset classes including private markets.

In its various forms, SQM Research has been issuing ratings on the private credit sector since 2008. Mortgage funds dominate its coverage with 37 products categorised as either open ended or contributory mortgage funds. Other major sub-categories, SQM Research rates within the private credit sector, include unconstrained fixed income products, diversified credit and alternative private debt.

SQM Research has current ratings on approximately 70 private credit funds, covering both retail and wholesale funds and representing approximately thirty-three billion dollars of funds under management, making it the largest researcher of private credit funds in the Australian funds management sector.

On the 20th of March 2025, SQM Research issued a 'sector watch' on the private credit sector in response to increased instances of issues observed and to recent announcements made by financial regulators, Australian Securities and Investment Commission (ASIC) and Australian Prudential Regulation Authority (APRA). A watch issued by SQM Research in this instance means that we are increasing our active monitoring of the sector on existing ratings, we have adjusted our ratings scoresheet to place a greater emphasis on governance; and that SQM's initial due diligence screening, which occurs prior to a formal review, will also be increased.

The issues SQM Research has observed include with increasing frequency have included

- Lack of transparency on who borrowers actually are.
- Questionable categorisation of asset holdings (illiquid/liquid/fixed income/convertible equity/equity).
- Lack of transparency on sub-fund holdings.
- Lack of transparency on group financials.
- Highly leveraged balance sheets.
- Overall inadequate disclosure within information memorandums.
- Information memorandums that give too much latitude to the manager in terms of asset allocation weights.
- Elevated Loan to value ratios, calculated on end of completion developments.
- Vertical and horizontal related party structures (same trustee, responsible entity, custodian, development/real estate agency divisions attached) that may give rise to a conflict of interest.
- Increased loan arrears and an increasing frequency of refinancing existing loans that were scheduled to be exited.
- Sizeable interest rate margins are not being passed onto investors.

- Lack of independence at board/ investment committee level.
- Dubious marketing strategies involving advisers.
- An increasing number of products being offered with a mismatch between stated liquidity and the underlying liquidity of the loan assets.

SQM Research stresses the above issues are not endemic within the sector, yet do appear with more frequency within wholesale funds and in particular, newer fund products offered to the market. Some of these issues have been observed beyond the private credit sector. Over the past 12 months SQM Research has screened out approximately 20 fund offerings within the private credit. The majority of these screened out products were in the wholesale sector. SQM Research conducts its due diligence using the same methodology, whether a fund is a retail or wholesale offering.

ASIC Discussion Paper - *Australia's Evolving Capital Markets*

In response to the discussion questions raised by ASIC from its discussion paper released February 2025 - *Australia's Evolving Capital Markets* as well as from the issues raised by SQM research above, SQM makes the following proposed solutions surrounding transparency measures:

Proposed transparency measures

A review of what is considered a liquid asset.
SQM has observed some loan products being classified as liquid where in SQM's opinion, such loan liquidity categorisations are questionable, particularly for higher risk loans and loan products that are non-performing.

This has had the effect where investors as well as third parties, such as research houses, are at risk of being unclear in terms of the real, underlying liquidity of a managed fund.

We believe a review of ASIC's definition of what it regards as a liquid asset should be reviewed, with a goal of providing more specific liquidity definitions and guidelines for all fund managers to observe when providing asset allocation information on their fund products.

Full disclosure required on related party lending.
SQM Research has observed on an infrequent basis, on wholesale fund product offerings, non-disclosure and not clear disclosure of related party lending or the ability to lend to related parties in the private credit sector. This lending has been observed at the director's level or involving related subsidiary parties.

At a minimum full and clear disclosure of such lending practices should be communicated to investors and other third parties such as research houses.

Limitations on related party lending.
Investor funds being used for directors' loans and consideration should be considered to limit lending on certain structures, such as where the end borrower is effectively the related party to the investment manager.

Information memorandum disclosure at levels commensurate with product disclosure statements.
Through the review of both retail and wholesale orientated funds, SQM Research has observed (on balance) a lower level of disclosure on information memorandums, the lower level of disclosure in the form on fee disclosure, risk parameters, target asset allocations, etc.

Notwithstanding our understanding of the limits to which ASIC can regulate the wholesale funds sector, we would propose regulation/guidelines that require all managers to have a minimum level of product disclosure no matter whether the product offering is retail or wholesale.

Standard risk measures as required by APRA for superannuation funds be adopted across product disclosure statements and Information memorandums.
This proposed measure would assist investors and other sector participants such as advisers, research houses and platforms to better understand the risk profile of the product offering.

Performance data such as returns, and asset allocation data reporting and collection should occur for the non-bank financial sector by a government body such as ASIC.
By having a regulatory authority having data oversight, this would reduce the risk of misreporting returns and asset allocation information. While SQM stresses such misreporting is a rare event, it has occurred and it is very difficult for research houses to identify returns/asset allocation data errors or deliberate misreporting, notwithstanding the inherent difficulties for any entity valuing certain illiquid assets.

In response to what other tools are available to support market integrity and the fair treatment of investors in private markets; SQM proposes the following:

A change in the threshold of what is a 'high net worth' individual/sophisticated investor
SQM Research has observed over recent years a significant increase in the number of wholesale fund product offerings across various asset classes; in particular, the private credit sector. We believe this has been driven in part by a rapid increase in the number of Australians who now qualify as a sophisticated wholesale investor/high net worth individual, the threshold of which is still set at $2.5 million dollars in net assets or a gross income of $250,000 per annum.

SQM Research understands the $2.5 million net asset threshold for sophisticated investors in Australia was set in 2001 when the Corporations Act 2001 was enacted. If we were to CPI index these thresholds to today's current dollars, the thresholds would sit at approximately $4.7 million dollars and the gross annual income threshold would be set at $470,000.

Making such a change would, in SQM's opinion, reduce the counts of what is in reality unsophisticated investors being classified as such and increased the counts of ASIC registered retail funds.

Another option is to consider a questionnaire base test for investors to complete.

SQM understands the definition of a sophisticated investor and the appropriate thresholds have been under recent Federal Government review; however, no change to the thresholds has yet been made and nor has a timeline for change been released.

Minimum capital requirements for non-bank financial institutions seeking to issue fund products to retail investors.
Minimum capital requirements to risk weighted assets has been in force in Australia for authorised deposit taking institutions for many years now, with effect that it has strengthened our banking sector. Such capital requirements are not in force for the non-bank financial sector, in part because the sector does not have retail depositors to protect in the sector.

However, thousands of retail investors have their funds invested with those non-bank financial institutions that offer fund products such as mortgage trusts. While trust structures are set up legally to provide separations between the fund manager and investor, major difficulties for investors can arise if the fund manager were to fail including the potential for significant investor losses.

Arguably, the non-bank financial sector writes loans which are higher risk compared to their banking peers. For example, there appears to be a higher proportion of loan exposure towards construction/property development. We would suggest this gives weight to the notion that there should be minimum capital requirements set for the non-bank financial sector whereby such institutions are in the business of operating investment fund products.

SQM Research welcomes further discussion with ASIC surrounding the issues and proposed solutions raised and puts this document forward for use in any further public discussion, recommendations or guidelines provided by ASIC in future.

For further information:

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