Woodbridge's Response to ASIC's Discussion Paper on the Dynamics Between Public and Private Markets.

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Developments in Global Capital Markets and Their Significance for Australia

1. What key impacts have global market developments had on Australian capital markets? What key impacts do you anticipate in the future? Please provide examples from your experience.

Past and Current Impacts on Australian Capital Markets

Increased Global Integration

- Impact - Over the past few decades, Australia's capital markets have become increasingly integrated with global markets. This has been facilitated by technology, regulatory alignment, and international financial flows. The Australian Securities Exchange (ASX) is now heavily influenced by global market sentiment, trends, and liquidity.
- Example - The 2008 Global Financial Crisis (GFC) is an example where global financial market instability led to sharp declines in Australian equities. Australian banks and corporations, which had global exposure, were severely affected by the liquidity crisis.

Exchange Rate Fluctuations

- Impact - The Australian Dollar (AUD) has historically been affected by fluctuations in global capital markets, particularly by commodity price movements (since Australia is a major exporter of raw materials) and interest rate differentials with other countries, especially the US.
- Example - The AUD often correlates with global commodity prices (oil, gold, etc.). For instance, during the Chinese economic boom, commodity prices soared, and the AUD appreciated significantly as global investors sought Australian exports. When the commodity boom ended in 2014, the AUD dropped.

Foreign Investment Inflows

- Impact - Australia's capital markets have benefitted significantly from foreign investment, which plays a critical role in funding Australian businesses. Foreign institutional investors often look to Australian markets due to their relative stability and high yields, particularly in sectors like banking, real estate, and mining.
- Example - The inflow of foreign direct investment (FDI) in the Australian real estate market has been substantial in recent years, with Chinese investors playing a major role in purchasing both residential and commercial properties. This has had a notable effect on property prices and market dynamics.

Regulatory Changes and Global Trends

- Impact - Australia's regulatory framework has adapted to global changes. For example, post-GFC, Australian financial regulators like the Australian Prudential Regulation Authority (APRA) and the Australian Securities and Investments Commission (ASIC) tightened regulations to ensure that Australian financial institutions remained robust in the face of global shocks.
- Example - In 2015, Australia introduced a set of reforms for the banking sector, which mirrored global efforts (Basel III) to ensure banks had stronger capital buffers and liquidity in the face of global risks.

Anticipated Future Impacts on Australian Capital Markets

Geopolitical Risk and Global Trade Shifts

- Impact - As geopolitical tensions (e.g., US-China trade disputes or the Russia-Ukraine war) continue, Australian capital markets will likely face more volatility. Australia's dependence on global trade, particularly in commodities, means that disruptions in global trade networks or trade policies can have a significant impact on market conditions.
- Example - Any escalation in global trade tensions or the impact of China's economic slowdown could harm Australian exports (e.g., coal, iron ore), affecting company profits and market sentiment.

Climate Change and Sustainability Focus

- Impact - Global developments in Environmental, Social, and Governance (ESG) criteria are influencing capital markets worldwide, and Australia is no exception. As institutional investors increasingly seek investments that align with sustainability goals, Australian companies that are leaders in ESG will see growing demand, while those that fail to adapt may face capital outflows.
- Example - In response to global pressure, Australian fund managers have started implementing more robust sustainability strategies, focusing on carbon neutrality, which has positively impacted their investor attractiveness.

Technological Advancements (Fintech, AI, Blockchain)

- Impact - Technological innovation is likely to play a significant role in shaping the future of global capital markets. Australia is already witnessing the rise of fintech companies and blockchain-based solutions that could disrupt traditional capital market structures.
- Example - The growth of Australian fintech companies like Afterpay and Zip Co demonstrates how technology is influencing local markets, especially in the payments and buy-now-pay-later sectors. Additionally, the ASX is in the process of transitioning to a blockchain-based clearing and settlement system, which will improve efficiency and transparency.

Global Interest Rates and Monetary Policy

- Impact - Interest rate changes by central banks, particularly the US Federal Reserve, will continue to affect Australian markets. Higher US interest rates could lead to capital outflows from emerging markets, including Australia, as global investors seek higher returns in developed economies. In contrast, lower global rates provide cheaper financing for Australian businesses & consumers, boosting economic growth.
- Example - When the US Federal Reserve raises interest rates, the AUD often weakens, which in turn affects Australian businesses that import goods. Conversely, when global rates are low, borrowing costs in Australia are reduced, benefiting businesses and consumers.

Post-Pandemic Economic Recovery

- Impact - The global recovery from the COVID-19 pandemic will continue to have profound effects on Australian capital markets. As countries emerge from pandemic-induced recessions, we are likely to see shifts in global demand patterns, investment flows, and supply chain dynamics.
- Example - Australia's relatively strong performance during the COVID-19 pandemic was partly due to its strong commodity export sectors, which performed well as demand from China and other regions rebounded. Similarly, as the global economy recovers, demand for Australian exports may increase, bolstering Australian markets.

2. Do you have any additional insights into the attraction of private markets as an issuer or an investor?

Attraction of Private Markets for Issuers

Flexibility and Control

Issuing in private markets offers companies more flexibility in terms of ownership and governance. They do not face the same level of regulatory scrutiny and public disclosure requirements as public market issuers. This allows companies to retain more control over their operations, strategy, and decision-making without the pressure of meeting earnings expectations from public shareholders.

Lower Costs of Capital

In private markets, especially through private equity or venture capital, companies can often secure capital without the hefty fees that accompany public offerings, such as underwriting costs, regulatory compliance, and ongoing reporting costs. In many cases, the cost of capital can be lower than in the public markets because investors in private deals are often more willing to accept risk in exchange for potentially higher returns. A company in its early growth stages, like Atlassian (which was once a private startup), may find that private equity or venture capital provides the necessary growth capital at a reasonable cost without needing to deal with the complexities of public markets.

Access to Strategic Investors

Issuing in private markets often provides access to strategic investors who are aligned with the company's long-term vision, not just looking for short-term gains. These investors may offer more than just capital; they can bring valuable expertise, networks, and operational support to help drive growth. Many Australian startups in sectors like technology and resources, such as Canva, have attracted private investors who not only provided funding but also contributed their industry knowledge and connections to help scale the business.

Long-Term Focus

Unlike public markets, where stock prices can be volatile and influenced by short-term investor sentiment, private investors typically have a longer investment horizon, focusing on building value over a longer period. This makes private markets especially attractive to companies looking for capital to execute long-term strategies without the pressure of immediate returns. Private equity investors often take a controlling stake in companies, allowing them to implement long-term operational and strategic changes. Crown Resorts, before it went public, was a good example where private equity involvement helped reshape & refocus the business.

Attraction of Private Markets for Investors

Potential for Higher Returns

Investors are often attracted to private markets due to the potential for higher returns, especially in venture capital or private equity, where they can access early-stage companies or businesses with significant growth potential. These investments are typically higher risk but can offer substantial upside if successful. For example, the cost of complying with retail regulations for a retail fund is approximately 50 basis points higher than a wholesale fund. Consequently, investors might prefer to be classified as wholesale to potentially achieve better overall investment returns.

Diversification

Private markets provide an avenue for portfolio diversification, which is especially appealing in lower interest rate environments where traditional asset classes (stocks, bonds) may offer limited growth potential such as during COVID. Investors can access a broader range of assets, including venture capital, private equity, direct investments, real estate, and infrastructure. Institutional investors (like pension funds and sovereign wealth funds) often allocate a portion of their capital to private markets to diversify away from public equities and fixed income securities. Australian superannuation funds, for instance, are increasingly investing in private equity, real estate and infrastructure projects.

Lower Correlation to Public Markets

Private market assets tend to have lower correlation to public markets, meaning their performance is not always tied to the same factors that affect the stock market. This can provide a hedge against market volatility and economic downturns.

Control and Influence

In private equity, investors often take an active role in the businesses they invest in, potentially taking board seats or influencing major business decisions. This is appealing for sophisticated investors who want more control over their investments and the opportunity to guide company strategy. For example, private equity firms such as Kohlberg Kravis Roberts (KKR) or Carlyle Group often take a hands-on approach in managing their portfolio companies, helping them streamline operations, enhance profitability, and achieve significant exits.

Access to Undervalued or Distressed Assets

In times of economic stress or market dislocation, private markets offer investors opportunities to buy undervalued or distressed assets. These investments can yield high returns when the assets are turned around or when market conditions improve. For example, during the GFC, many private equity firms took advantage of distressed assets in sectors like banking, real estate, and manufacturing. In Australia, private equity firms have been known to acquire distressed mining or energy assets and restructure them for profit.

<u>Considerations and Risks</u>

While private markets are attractive, both issuers and investors must weigh the risks and challenges:

- <u>Liquidity Risk</u> - Investments in private markets are less liquid than in public markets. This means that investors may have to hold their investments for a longer time before they can exit, which can be a significant drawback for those looking for quicker returns.
- <u>Valuation and Transparency</u> - Private market assets are harder to value compared to public securities, and there is often less transparency. Investors may face challenges in accurately assessing the risk and value of these investments.
- <u>Regulatory and Legal Complexity</u> - Issuing in private markets, particularly in international settings, can involve complex regulatory frameworks that need to be navigated, which could add costs or delays.

3. In what ways are public and private markets likely to converge?

Private Capital for Public Companies

Public companies are increasingly tapping into private capital (e.g., private equity or venture capital) to raise funds without the complexities of public offerings, and some are adopting dual class shares to maintain control while accessing public markets.

Private Equity and Venture Capital Going Public

More private equity and venture capital-backed companies are likely to go public via alternative methods like Special Purpose Acquisition Companies or direct listings, which bypass traditional IPO processes.

Hybrid Investment Vehicles

Public investors will gain easier access to private market investments through listed private equity funds, venture capital funds, listed investment companies, allowing for greater diversification and exposure to private assets while maintaining public market liquidity.

Regulatory and Transparency Reforms

Regulatory bodies may introduce reforms to improve transparency and investor protection, facilitating smoother transitions between public and private markets.

Tech and Digital Platforms

Digital platforms for trading private equity or other private assets are expanding, enabling retail investors to access private markets. Additionally, blockchain technology could speed up transactions in both public and private markets.

4. What developments in public or private markets require regulatory focus in Australia in the future?

Digital and Blockchain Assets

Regulators must address the rise of digital assets, including cryptocurrencies and tokenized securities, ensuring investor protection and managing associated risks.

Private Market Participation

With more retail investors accessing private markets (e.g., via crowdfunding or private equity), regulators need to ensure liquidity, disclosure, and investor protection.

New Financial Products

Innovation in financial products like derivatives linked to private assets requires clear regulatory oversight to manage risks and protect investors.

Market Integrity and Fraud Prevention

Regulators must enhance protections against fraud and market manipulation, especially with the rise of digital platforms for private market trading.

Secondary Market for Private Investments

Creating a regulated secondary market for private equity, private credit and venture capital investments will be crucial to provide liquidity while ensuring fairness.

Global Regulatory Alignment

To remain competitive, Australia must align its regulations on digital assets, taxation, and cross-border trading with international standards.

Corporate Governance

With complex ownership structures, regulators need to ensure strong corporate governance to maintain accountability and protect shareholders.

Retail Investor Protection in Private Markets

Clear regulations are needed for retail investors accessing private markets to ensure they understand risks, especially in less liquid investments.

Healthy Public Equity Markets

5. What would make public markets in Australia more attractive to entities seeking to raise capital or access liquidity for investors while maintaining appropriate investor protections?

Regulatory Adjustments

- Streamlined Listing Processes - Simplifying the IPO process and reducing the regulatory burden can make it easier for companies to go public
- Enhanced Transparency - Improving the transparency of regulatory requirements and ensuring consistent enforcement can build trust among investors

Investor Protections

- Robust Governance Frameworks - Implementing strong corporate governance practices, including clear shareholder rights and board accountability, can protect investors and enhance market confidence
- Effective Dispute Resolution - Ensuring efficient and accessible dispute resolution mechanisms for investors can address grievances promptly and fairly

Market Incentives

- Tax Incentives - Offering tax benefits for companies that list on public markets can encourage more entities to consider this route
- Support for Innovation - Providing support for innovative sectors and emerging industries can attract high-growth companies to public markets

Education and Awareness

- Investor Education - Enhancing investor education programs to improve financial literacy can empower investors to make informed decisions
- Market Awareness Campaigns - Promoting the benefits of public markets through targeted campaigns can attract both domestic and international investors

Technological Advancements

- Digital Platforms - Leveraging technology to create more efficient trading platforms and improve market accessibility can attract a broader range of investors
- Data Analytics - Utilizing advanced data analytics to monitor market trends and investor behaviour can help regulators and market participants make informed decisions.

6. Do you agree that a sustained decline in the number, size or sectoral spread of listed entities would negatively impact the Australian economy? If so, can you suggest ways to mitigate any adverse effects that may arise from such changes?

A sustained decline in the number, size, or sectoral spread of listed entities could negatively impact the Australian economy by reducing market liquidity, lowering investor confidence, and diminishing capital formation, which are crucial for economic growth. Fewer listed entities can lead to lower trading volumes, making it harder for investors to buy and sell shares without affecting prices. This can erode investor confidence, leading to reduced investment and higher volatility. Additionally, with fewer companies raising capital through public markets, there may be less funding available for business expansion and innovation. A lack of diversity in listed sectors can also make the market more vulnerable to sector-specific downturns.

To mitigate these adverse effects, several strategies can be implemented. Encouraging IPOs and listings through tax breaks or subsidies and simplifying regulatory requirements can make it easier for companies to go public. Enhancing market attractiveness by improving corporate governance standards and promoting market diversity can boost investor confidence and reduce vulnerability to sector-specific risks. Supporting innovation and growth through grants and funding for startups, as well as offering R&D tax credits, can attract high-growth companies to the market. Additionally, enhancing investor education and ensuring strong legal protections can build trust and encourage participation in public markets. By implementing these strategies, Australia can maintain a vibrant, resilient public market and mitigate the adverse effects of a decline in listed entities.

7. To what extent is any greater expectations of public companies, compared to private companies, the result of Australian regulatory settings or the product of public scrutiny and community expectations of these companies?

The greater expectations placed on public companies in Australia compared to private companies stem from a combination of regulatory settings and public scrutiny, along with community expectations.

Regulatory Settings

Public companies are subject to more stringent regulatory requirements than private companies. These include mandatory disclosure obligations, such as the need to provide detailed financial reports and directors' reports annually, which must be independently audited.

Public companies must also comply with continuous disclosure rules, ensuring that any material information that could affect the company's share price is promptly made public.

These regulations are designed to protect investors and maintain market integrity by ensuring transparency and accountability.

Public Scrutiny and Community Expectations

Public companies face higher levels of scrutiny from investors, analysts, the media, and the general public. This scrutiny is partly due to the broader ownership base, as shares are available to the general public, making the company's performance and governance a matter of public interest.

Community expectations also play a significant role, as seen in the aftermath of the banking Royal Commission, where there was a strong emphasis on corporate behaviour, governance, and ethics. The public expects higher standards of conduct from companies that have a significant impact on the economy and society.

Combined Impact

The combination of regulatory requirements and public scrutiny creates a framework where public companies are held to higher standards. This dual pressure ensures that public companies operate transparently and ethically, fostering trust and confidence among investors and the broader community.

Private Market Risks and Market Efficiency and Confidence

8. Are Australian regulatory settings and oversight fit for purpose to support efficient capital raising and confidence in private markets? If not, what could be improved?

Australian regulatory settings and oversight are generally effective in supporting efficient capital raising and maintaining confidence in private markets.

ASIC has established a robust regulatory framework that ensures transparency and investor protection, including stringent disclosure requirements and governance standards. Australia's equity markets operate with a high level of integrity, consistently ranking among the cleanest in the world, which fosters investor confidence and supports efficient capital raising.

However, there are areas for improvement. Enhancing ASIC's data and information gathering capabilities would allow for better risk identification and management. Adjusting regulatory settings to simplify the listing process and reduce the regulatory burden on companies could improve market attractiveness. Increasing transparency in private markets and ensuring robust investor protection mechanisms can further enhance market confidence. Providing additional support for innovative sectors and emerging industries, such as targeted grants, tax incentives, and R&D credits, can attract high-growth companies to private markets.

By addressing these areas, Australia can further strengthen its regulatory settings and oversight, ensuring they remain fit for purpose in supporting efficient capital raising and maintaining confidence in private markets.

Focusing on private credit regulation we note the following;

- AFSL Licencing – The provision of a credit facility is generally not a financial product and providing loans generally does not require an AFSL and the regulations that come with the licencing. The AFSL regime is more relevant to credit funds operating in Australia in connection with the offering of the funds interests and managing the assets of the fund. As such, an AFSL is needed in respect of the issuer of the fund interests or for a promoter of the fund.
- APRA Licencing – APRA collects data from registered financial corporations (RFC's) however, an entity is only required to register with APRA where the loans/financing exceeds $50million. The data collected includes information about the financial position and details about the loans. Often in private credit each loan is structured through a separate legal entity (ie a special purpose vehicle). The requirement to register with APRA is on an individual entity basis and there is no requirement to group related entities which means that an investment manager could have billions in loans but, if each of them are under $50M, there is no requirement to register with or report to APRA. The implication is that APRA is potentially not receiving full transparency on the size of the non-bank lending market in Australia.

9. Have we identified the key risks for investors from private markets? Which issues and risks should ASIC focus on as a priority? Please explain your views.

The following responses are provided only in regard to private credit funds - we believe ASIC needs to significantly widen its view of risk in this asset class.

Liquidity Risk

Liquidity risk in private credit funds refers to the difficulty investors may face in selling their investments quickly or at a fair price. This risk is inherent in private markets due to the lack of a liquid secondary market for many private instruments.

The key aspects of liquidity risk are;

- <u>Illiquid Investments</u> - private market funds often invest in asset and loans that are not publicly traded, making it challenging to sell these assets quickly without significant price concessions. If redemption requests exceed the fund's capacity, it may be forced to liquidate more-liquid holdings first, leaving a higher concentration of illiquid assets in the fund.
- <u>Redemption Pressure</u> - during periods of market stress, investors may seek to redeem their investments en masse, which can force funds to sell assets at unfavourable prices or halt redemptions altogether.

- Market Conditions - economic downturns or financial crises can exacerbate liquidity issues.

To mitigate liquidity risk, private market funds can implement measures such as maintaining a liquidity buffer, diversifying their portfolios, and establishing clear redemption policies. Additionally, funds can use stress testing to assess their ability to meet redemption requests under various market scenarios.

We also believe the market and investors should continue to educate themselves around the potential illiquidity of the asset class. Whether this is through appropriate disclosures in the Target Market Determination (TMD) and Product Disclosure Statement (PDS) / Information Memorandum (IM) or education resources provided by ASIC and/or APRA.

Conflicts of Interest Risk

The Investment Manager Providing a Loan to a Related Party.

In certain circumstances, there has been occasions of investment managers lending to themselves / their own projects. We have seen this disclosed in PDS / IM's that the manager can do this however we don't believe that investors currently fully understand what it means and why it is a conflict.

The Investment Manger Providing a 1st and 2nd Mortgage on the Same Loan.

Some investment managers have allowed two different sets of investors to lend to the same asset. The loans are typically structured as follows -

- Senior loan (1st ranking) up to say a 65% loan to value ratio
- Subordinated loan (2nd ranking) between say a 65% to 75% loan to value ratio

It is a conflict for the following reasons -

- As the senior lender, the primary concern is to ensure the company repays its debt on time and in full by minimizing risk. As a mezzanine lender, they are further down the priority chain and are taking on higher risk in exchange for the potential of higher returns. The focus may be on maximizing the upside potential.
- A senior lender may push for more conservative actions to ensure repayment, but a mezzanine lender, may prefer riskier strategies that maximize potential returns.
- As a senior lender, you might want to enforce restrictive covenants however this may impact the mezzanine returns and repayment.
- In case of default or bankruptcy, the senior lender has a first priority in terms of asset recovery. However, a mezzanine lender, is further down the line and may not recover anything if the company's assets are insufficient to cover senior debt. Will an investment manager fully protect the senior investor and sell an asset below the mezzanine debts value?

This was detailed in the below AFR article.

https://www.afr.com/companies/financial-services/maxcap-investor-groups-face-off-over-stalled-byron-bay-project-20250102-p5l1oa

Whilst all investment managers pertain to have a relevant conflicts of management policy, at the end of the day the manager may do as they see fit and may attempt to satisfy both investors (senior and mezzanine) and may delay asset sales in event of default and recovery. Ultimately, a senior investor may not have control of the asset as the investment manager has chosen to prioritize the mezzanine investor.

It is possible that because some investors are in a fund, they may not see the loans the manager is making and may not even be aware that the manager is doing this.

It is becoming evident that related entities should not invest in different loans to the same assets. For example, if it was a third-party mezzanine lender ranked behind the senior lender / underlying investor, there would be no ultimate conflict, and the best interests of the investor would always be satisfied.

Self-Rating Credit Risk

Investment managers should not be self-rating their own credit (i.e. allocating a credit rating to their loans). The private credit loans should be unrated. We have seen an instance of a lender saying their loans are BBB rated which we are not sure how this is possible. It is possibly a highly misleading representation to investors as to the risk of the product.

External Fund Trustee

In a private credit fund, appointing an external trustee/responsible entity is critical to safeguarding investor interests and ensuring true transparency around risk and returns. Without an independent third-party overseeing fund operation, the investment manager retains unchecked control over reporting, asset valuation, and risk exposure—creating a significant conflict of interest. This lack of oversight can lead to misrepresentation of portfolio performance, understated risks, or selective disclosure of information, ultimately leaving investors exposed to losses they were not fully aware of. An external trustee/responsible entity acts as an impartial gatekeeper, ensuring adherence to the fund's mandate, verifying valuations, and holding the manager accountable—thereby reinforcing trust, protecting investor capital, and preserving the integrity of the fund.

External Fund Administrator

Independent unit pricing is essential in a fund to ensure fair and accurate valuation of investor holdings, free from potential bias or manipulation by the investment manager. Accurate unit pricing directly impacts how investors enter, exit, and assess their positions in the fund, making it a critical component of transparency and investor protection. When combined with the oversight of an external trustee/responsible entity, independent unit pricing provides an additional layer of assurance that valuations are conducted impartially and in accordance with the fund's governing documents. The trustee/responsible entity acts as a safeguard, monitoring the process to ensure valuations are independently verified and reflective of true market conditions. Together, independent unit pricing and trustee/responsible entity oversight create a robust framework that enhances investor confidence, mitigates conflicts of interest, and promotes full transparency around the fund's performance and risk exposure.

Valuation Risk

Valuation risk in private credit funds refers to the uncertainty and potential inaccuracies in determining the fair value of the investments within these funds. This risk arises due to the lack of transparency and the subjective nature of valuing private credit assets, which can lead to discrepancies between the reported value and the actual market value.

The key elements of valuation risk are;

- Subjectivity in valuation - unlike public markets, where asset prices are readily available, private credit investments often lack a clear market price. Valuations are typically based on models and assumptions, which can vary significantly between managers. For example, one manager might use a discounted cash flow model, while another might rely on market comparables, resulting in different valuations for the same asset.
- Market Conditions - changes in market conditions, such as credit spreads and interest rates, can impact the valuation of private credit assets. These changes can be difficult to predict and incorporate into valuation models
- Credit Quality - the performance of the underlying companies/borrowers/builders in which the private credit funds invest can affect valuations. Deterioration in credit quality of these parties can lead to significant write-downs
- Impact of Leverage - funds that use leverage to enhance returns can face amplified valuation risks. If the underlying assets' values decline, the impact on the fund's net asset value can be more pronounced due to the leverage employed

To mitigate valuation risk, private credit funds can adopt best practices such as establishing and following a robust valuation policy that conforms to fair value standards set by bodies like the Financial Accounting Standards Board (FASB) and the International Financial Reporting Standards (IFRS).

Regularly reviewing and updating valuation models, incorporating market data, and ensuring transparency in the valuation process can also help reduce this risk.

Operational Risk

Operational risks arise from inadequate processes, systems, or controls within the companies or funds in which investments are made. This can result in significant losses for investors.

To mitigate operational risk, private credit funds can implement robust internal controls, invest in advanced technology and cybersecurity measures, provide comprehensive training for staff, and develop contingency plans for external events. In addition to this, the parties involved in the administration and management of funds (i.e. responsible entities, custodian, administration and investment managers) can have these internal controls audited by an external audit firm (i.e. GS007 audit).

Disclosure of Leverage

Investment managers will sometimes use leverage at the fund level to finance loans they are making. They do this to increase investment returns. However, we are yet to see a manager properly disclose this to investors in reporting. For example, the use of fund leverage should be:

- Shown on a monthly basis (if they are reporting monthly to investors).
- How much leverage is being used should be disclosed.

This will help investors understand how an investment manager delivers a return and the associated risk they have taken on to improve their returns using leverage.

It is also very difficult for an investor to currently compare the performance of funds and investment managers when some use leverage and some don't. Other key points include:

- Increased Risk of Losses - Leverage amplifies both gains and losses. While it may increase returns during good performance, but it also magnifies losses if the investments don't perform as expected.
- Liquidity Risk - Private credit funds typically invest in less liquid assets, such as private loans. When leverage is used, the fund may face difficulties in meeting its obligations if the value of its assets drops or if there's a liquidity shortfall, potentially leading to forced asset sales at unfavourable prices or unable to meet redemptions.
- Impact on Investor Confidence - Overusing leverage in a private credit fund can lead to concerns among investors about the fund's risk profile. It could result in a loss of investor confidence, reducing the ability to raise new capital or leading to investor withdrawals.

Disclosure of Fees

The fees to the investment manager for originating and managing the loans are often not disclosed in the IM / PDS. It is up to the manager to determine what is a fair and reasonable split of income generated from a loan between parties (investment manager and returns to investors).

Typically, origination fees are paid to the investment manager, while the investor receives the interest and line fees less a management fee. Investors should have visibility into the origination and other fees received by the an investment manager. The best approach to achieve this transparency might be to ensure:

- All fees (origination, line fees and other fees) and interest are directed to the fund
- The fund then charges a single management fee which provides transparency of total fund manager fees.

Disclosure in Monthly Reports

The monthly reporting offered to investors varies significantly. At a minimum, monthly reporting should be standardised to show certain characteristics in the loan portfolio:

- Actual asset allocation to each asset type
- Liquidity profile of the portfolio assets
- Maturity profile of the liabilities – ie Loan term and loan term remaining
- Derivative counterparties

- Leverage ratio (including leverage embedded in the assets of the Fund)
- Key services providers and changes to those providers
- Defaults, arrears and any provision for impairments
- Average Loan to Value ratio
- Breakdown of security (senior, mezzanine, equity)
- Number of loans
- Should show all historical monthly performance and relevant returns over recent periods.

Whilst reporting the full loan book (showing underlying loans) may not be feasible to show every month, there should at least an annual reporting of the full loan book (showing underlying loans).

In addition, transparency of similar information on sub-fund holdings should also be disclosed.

10. What role do incentives play in risks, how are these managed in practice by private market participants and are regulatory settings and current practices appropriate?

Incentives play a crucial role in shaping the risk-taking behaviour of private market participants. They can drive both positive outcomes and potential risks, depending on how they are structured and managed. For example;

- Incentives, such as performance fees and carried interest, are designed to align the interests of fund managers (general partners or GPs) with those of investors (limited partners or LPs). This alignment encourages managers to pursue strategies that maximize returns.
- Risk-Taking Behaviour: Incentives can also influence the level of risk that managers are willing to take. For example, performance-based compensation may encourage managers to undertake higher-risk investments to achieve higher returns.

Incentives are management in practice by;

- One common practice to align incentives is co-investment, where fund managers invest their own capital alongside that of their investors. This ensures that managers have a personal stake in the fund's performance, aligning their interests with those of the investors
- To mitigate the risk of excessive risk-taking, many private market funds include clawback provisions. These provisions allow investors to reclaim a portion of the performance fees if the fund underperforms in subsequent periods.
- Regular and transparent reporting of fund performance and risk exposure helps investors monitor the alignment of incentives and the associated risks. This practice enhances trust and accountability between managers and investors

Regarding private credit, performance fees in credit funds can create a major conflict of interest and misalignments with investors' goals.

- Credit investments - Typically have a focus on capital preservation and income so incentivising managers to take on more risk is not fitting with allocating capital to a credit fund typically.
- Conflicts of Interest: Managers might prioritise their own compensation over the best interests of investors. For example, they may favour riskier loans that offer higher potential returns to generate a higher performance fee.
- Excessive Fees - Performance fees may be quite high, which means that a significant portion of the fund's profits goes to the manager instead of the investors. This can lead to a situation where investors are not fully benefiting from the returns they are entitled to, especially in cases when the fund underperforms.
- Improper Loan Valuation - Managers may have an incentive to inaccurately mark a loan or misstate the fund's unit valuation to boost the performance and generate higher performance fees.

Retail Investor Participation in Private Markets

11. What is the size of current and likely future exposures of retail investors to private markets?

The current exposure of retail investors to private markets in Australia has been growing, particularly through their participation in superannuation funds. Superannuation funds often allocate a portion of their investments to private markets, including private equity and private credit, providing retail investors with indirect exposure to these assets

The trend of increasing exposure to private markets is expected to continue as superannuation funds seek to diversify their portfolios and enhance returns. As private markets evolve, retail investors' exposure is likely to grow, driven by the search for higher yields and the potential for capital appreciation.

There has been a recent flurry of new listed investment companies (LIC) on the ASX attracting new retail investors. These new LIC’s should take into consideration issues raised in question 10 above.

12. What additional benefits and risks arise from retail investor participation in private markets?

Benefits

- More opportunities to diversify investment portfolios
- Less reliance on equities and bonds performance
- Ability to get consistent income from the asset class

Risks

- Illiquidity of private market investments
- Investor expectations regarding returns are net met
- Misaligned incentives and conflicts of interest on the part of managers of retail private capital funds and superannuation funds
- Inflated fees or expenses
- Misleading information on performance
- Inappropriate valuations
- Loss of capital

13. Do current financial services laws provide sufficient protections for retail investors investing in private assets (for example, general licensee obligations, design and distribution obligations, disclosure obligations, prohibitions against misleading or deceptive conduct, and superannuation trustee obligations)?

Current financial services laws in Australia provide a robust framework for protecting retail investors investing in private assets, but there are areas where improvements could enhance these protections further. For example;

- Enhancing transparency around the valuation of private assets can help investors better understand the risks and potential return
- Improving liquidity management practices can protect investors from the risks associated with illiquid investments
- Strengthening regulatory oversight of private market participants can ensure that they adhere to high standards of conduct and governance

Transparency and Monitoring of the Financial System

14. What additional transparency measures relating to any aspect of public or private markets would be desirable to support market integrity and better inform investors and/or regulators?

Enhancing transparency in both public and private markets is crucial for maintaining market integrity and ensuring that investors and regulators are well-informed. Here are some desirable measures:

- **Enhanced Disclosure Requirements:** Companies should provide more detailed and frequent disclosures about their financial health, governance practices, and risk factors. This includes regular updates on financial performance, detailed breakdowns of revenue sources, and comprehensive risk assessments
- **Real-Time Reporting:** Implementing real-time reporting of significant transactions and market activities can help regulators detect and address market manipulation and insider trading more effectively
- **Standardized ESG Reporting:** Mandating standardized reporting on Environmental, Social, and Governance (ESG) factors can provide investors with consistent and comparable data, helping them make more informed decisions
- **Public-Private Collaboration:** Encouraging collaboration between public regulators and private entities can lead to the development of more effective transparency measures and compliance programs
- **Technological Integration:** Leveraging advanced technologies like blockchain for transparent and immutable record-keeping can enhance the integrity of financial transactions and reporting. Smart contracts on the blockchain can automatically enforce compliance with regulations and agreements. This reduces the need for manual oversight and increases transparency in regulatory processes.

15. In the absence of greater transparency, what other tools are available to support market integrity and the fair treatment of investors in private markets?

In the absence of greater transparency, several tools and practices can help support market integrity and ensure the fair treatment of investors in private markets:

- **Robust Valuation Practices:** Ensuring that valuations of private market assets are conducted independently and consistently can help maintain investor confidence and market integrity
- **Third-Party Audits:** Regular audits by independent third parties can provide an additional layer of oversight and assurance that financial statements and valuations are accurate
- **Enhanced Regulatory Oversight:** Regulatory bodies can implement stricter oversight and enforcement mechanisms to ensure compliance with existing rules and to detect and prevent fraudulent activities
- **Investor Education:** Providing investors with education and resources about the risks and opportunities in private markets can help them make more informed decisions
- **Whistleblower Programs:** Encouraging and protecting whistleblowers who report unethical or illegal activities can help uncover and address issues that may not be visible through regular oversight
- **Standardized Reporting:** Implementing standardized reporting requirements for private market participants can help ensure that all investors have access to comparable and reliable information
- **Conflict of Interest Policies:** Establishing and enforcing policies to manage and disclose conflicts of interest can help ensure that decisions are made in the best interest of investors.

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