Australian Private Equity &
Venture Capital Association Limited

Financial System Inquiry

Round 2 Submission

August 2014

26 August 2014

Mr David Murray AO
Chair, Financial System Inquiry
GPO Box 89
SYDNEY NSW 2001

By email: fsi@fsi.gov.au

Dear Mr Murray,

The Australian Private Equity & Venture Capital Association Limited welcomes the opportunity to put forward this Round 2 submission to the Financial System Inquiry.

The Interim Report released by the FSI recently has provided us with a clear understanding of the key focus areas that you and your colleagues will be closely examining throughout the remaining phases of this review.

For our industry, we will be anticipating that in your final report there will be a range of structural recommendations that are aligned with facilitating an increase in the capacity of the private sector to invest in small, medium and large Australian businesses through private equity and venture capital. As acknowledged in the Interim Report, our industry can be a major catalyst for increases in productivity and innovation across the business sector, both of which are vitally important ingredients for a stronger Australian economy into the future.

We look forward to continuing to actively participate in the work of your Inquiry, and to assisting in any way we can with further information as part of the next steps of the consultation process.

If you would like to discuss any aspect of our submission further, or require any additional information from our industry, please do not hesitate to contact me or Dr Kar Mei Tang on 02 8243 7000.

Yours sincerely

Yasser El-Ansary
Chief Executive
AVCAL

ABOUT AVCAL

The Australian Private Equity & Venture Capital Association Limited (AVCAL) is the peak body representing Australia's venture capital (VC) and private equity (PE) industry. Our industry has a combined total of over $24 billion in funds under management for a wide range of domestic and offshore investors, including Australian-based industry and retail superannuation funds.

CONTENTS

ABOUT AVCAL 3
CONTENTS 4
EXECUTIVE SUMMARY 6
1. FUNDING SMES 9
1.1. Challenges faced by SMEs in accessing capital 9
1.1.1. Importance of financing SMEs 9
1.1.2. Debt and equity are harder to access for SMEs, than for households and big business 9
1.1.3. Innovative young businesses will find it particularly difficult to access traditional financing 10
1.1.4. Traditional financing failed SMEs during the financial crisis 10
1.1.5. Role of PE and VC in addressing SME challenges in accessing finance 11
1.2. Addressing barriers to the growth of VC 12
1.2.1. Transparency of PE and VC fees 12
1.2.2. Removing roadblocks to superannuation investment in VC 14
1.2.3. Simplify the tax treatment of VCLPs 16
1.2.4. Improve access to R&D quarterly tax credits by new ventures 19
1.3. Crowd-sourced equity funding 20
1.4. Reduce the complexity and cost of external administration for businesses 21
2. SUPERANNUATION 22
2.1. Fee competition and net returns 22
2.1.1. Optimal diversified portfolio is not always made up of low-cost assets 22
2.1.2. Ultimate objective of super is adequate retirement income 23
2.2. Promoting a long-term focus 24
2.3. Passive vs active asset management 25
3. INTERNATIONAL INTEGRATION 27
3.1. Tax treatment of managed funds 27

Executive Summary

EXECUTIVE SUMMARY

One of the most significant challenges facing Australia today is how its financial system will support the next wave of economic growth through expansion of the pool of capital available to invest in local businesses.

After many years of prosperity on the back of strong resource and commodity market activity, Australia must now turn its focus to boosting economic productivity. Decisive action is needed to set the framework for enduring prosperity in the face of the major economic forces that are at play both domestically and internationally.

We know that there is a structural shift taking place across the manufacturing industry as a result of globalisation. And in addition, there is an ageing population which will place increasing pressure on government finances through support for the age pension and rising healthcare costs. These factors also have a direct impact on businesses, by creating a new wave of succession planning challenges.

These are only some of the reasons why this Inquiry must identify the key reform priorities that are necessary for the financial system to meet these significant challenges over the medium to long-term.

The role played by private equity and venture capital firms in supporting more private capital investment in Australian businesses is very significant. The businesses invested in by the industry support around 4% of the nation's annual economic output and around half a million jobs across a wide range of industries, especially in new and high growth potential markets.

However, the role of the industry as a conduit between private capital and investment-hungry businesses faces a number of significant challenges that currently act as a 'handbrake' on further investment flows to those businesses that need it the most. There are a range of tax measures, for example, that need to be considered as part of the Government's Tax White Paper, which will help to improve the capacity of private equity and venture capital to invest in Australian businesses.

One of the most significant challenges faced by the industry, however, is the decline in the supply of capital flowing to private equity and venture capital funds to be invested locally. In Australia, the amount of capital invested by superannuation funds into this industry equates to an estimated 1% of the total current superannuation savings pool of $1.8 trillion. That is a very small aggregate amount, especially when compared against the equivalent allocation in other markets such as the United States where the allocation to the asset class averages somewhere around 9% or 10 %.

Since the introduction of MySuper and the increased focus on low-cost superannuation portfolios, there has been a shift by superannuation funds to low-cost highly liquid asset classes, such as equities and fixed interest. However, there are important questions that have to be answered about whether this approach is best aligned with achieving the long-term objectives of reducing reliance on the age pension and maximising retirement incomes for superannuants. The problem with a singular focus on lowest-cost options is that in many cases, alternative asset classes such as private equity (which are not generally regarded as low-fee) have often outperformed other asset classes on the basis of long-term returns, even after fees have been accounted for.

Fundamentally, the Inquiry needs to look at how policy settings can be re-calibrated towards ensuring a more appropriate balance is struck between short and long-term investment strategies for superannuation funds. Superannuation reporting and disclosure frameworks need to be designed to encourage a focus on members' ultimate retirement income adequacy, rather than short-term returns or static fee metrics that are at best imperfect measures of the true cost of investment. Adopting such an approach will help to ensure that fund members frame their decisions on the metrics that are geared towards delivering the best outcomes for them in retirement, while at the same time driving economic activity that leads to increases in the standard of living and employment opportunities for future generations of Australians.

This will not only help create a sustainable retirement income system for all Australians, but by extension, provide a major economic pay-off to the nation as a whole through the efficient and effective distribution of capital to private businesses and growing sectors that would otherwise struggle to find funding.

The interim report has provided the framework for a deeper conversation around some of these challenges, which is especially timely given the effect of the various macro forces at play across our economy are beginning to be felt right now.

Submission to the Financial System Inquiry

1. FUNDING SMES

1.1. Challenges faced by SMEs in accessing capital

1.1.1. Importance of financing SMEs

The Report has appropriately recognised the importance of SMEs to the economy, innovation and productivity, particularly given the fact that Australia's two million SMEs employ around 70% of the workforce – which is large by international standards – and account for over half of private sector output. Small businesses are also an important source of innovation across the economy, comprising almost 90% of all businesses engaging in innovative activity.[1]

However, it is also widely recognised that SMEs face many barriers to innovation – including access to funding – and that there is potential for more firms to innovate with the removal of these barriers.[2] In a study for NSW Business Chamber in 2013, Deloitte Access Economics estimated that about 10% of Australian SMEs (or around 200,000 businesses in total) experience difficulty in accessing finance.

The NSW Business Chamber research indicated that around 30% of SMEs felt that they had missed a good business opportunity due to the lack of availability of credit. The same study highlighted ABS data which suggests that access to finance is also the most common barrier to innovation (affecting around 400,000 businesses) and the third most significant barrier to increases in general business activity (affecting around 300,000 businesses).

1.1.2. Debt and equity are harder to access for SMEs, than for households and big business

Smaller businesses typically access bank lending on less favourable terms than either households or larger businesses: they pay more, on average, for debt than both households and larger businesses in terms of both interest rates and product fees.[3] Their revenue streams are more volatile, and they have to make greater use of riskier forms of collateral such as inventory, vehicles, equipment and accounts receivable, and make more use of unsecured debt products.

RBA analysis shows that small business borrowers are more than twice as likely as standard mortgage customers to default. For SMEs that increasingly operating in the digital economy with operations that do not fit neatly into traditional credit risk models, difficulties in accessing debt financing can become even more acute.

The higher volatility of small business revenue streams also makes equity, like debt, more costly for smaller businesses. Small business equity investors (including the owners) require a higher average return on equity to compensate for the higher uncertainty of the return.

For SMEs, equity capital is typically raised internally through profits from the owner, or from friends and family (see Figure 1) as the high costs of listing make public capital markets unattractive to all but a small number of SMEs.

VC and PE are valuable alternative channels of equity financing, but their sources of funding are becoming increasingly constrained due to the withdrawal of policy support for the VC industry, and other policy and tax-related roadblocks constraining institutional investment into the PE asset class.

These factors are serving to tighten the channels through which funds can flow to SMEs both now and in the future. This makes it more important that the finance channel to SMEs from other sources, including PE and VC, is not impeded.

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[1] Connolly, E., D. Norman and T. West, *Small Business: An Economic Overview*, RBA Small Business Roundtable, May 2012.

[2] Department of Innovation, Industry, Science and Research, *Key Statistics Australian Small Business,* 2011.

[3] Matic, M., A. Gorajek and C. Stewart, *Small Business Funding in Australia*, RBA Small Business Roundtable, May 2012.

Table 1 shows the main sources of external funding for businesses, to help highlight the challenges faced by SMEs as compared to large businesses. It should be noted that the Report has highlighted two possible solutions that are hoped to alleviate the access to finance problems for SMEs: crowdfunding and peer-to-peer lending. Both are still in their infancy around the world and Australian regulation is still being developed in this area.

As a result, neither channel – while helpful in laying the groundwork for further innovation in this area – are expected to ameliorate the funding challenges faced by SMEs by any significant measure in the short-term.

Table 1: Sources of External Funding for different types of entities (existing and *new* channels)

Type of capital	SMEs	Large Businesses
Equity	**Owners, family and friends:** main source of equity **VC & PE:** limited supply **Angel investors, accelerators:** limited supply, invest in small amounts ***Crowdfunding:*** *regulation still being developed. Likely to be limited to small amounts given the target market and potential investment limits.*	**Stock exchange listing** **Direct institutional investors**, e.g. superannuation funds, large buyout funds, hedge funds
Debt	**Banks loans:** main source of debt; mainly by local banks **Finance companies:** share of business lending has declined over the years **Trade credit:** less used by SMEs than large business. ***P2P lenders:*** *regulation still being developed.*	**Bank loans**: local and international (usually with better terms than SMEs) **Trade credit** **Listed/unlisted bonds**: local and international **Other debt, hybrids** securities markets **Non-bank lenders** e.g. hedge funds.

1.1.3. Innovative young businesses will find it particularly difficult to access traditional financing

Many observers are also seeing a change in the way value in small business is created. The emergence of more fast-growing, technology-centric, but asset-poor, small businesses poses particular challenges for both the suppliers and demanders of capital.

Table 2 highlights some key differences between access to finance by traditional small business and new digital-era innovative startups and small business.

1.1.4. Traditional financing failed SMEs during the financial crisis

The global financial crisis in the late 2000s saw a decline in most external financing channels for SMEs. Many businesses failed or found that apparent opportunities could not be taken up.

While most business segments deleveraged, businesses with listed equity capital (typically bigger businesses) were able to raise further

equity through secondary share issues (albeit at deep discounts) to institutional investors to help repay bank debts. This was not an option for SMEs.

As long as SME loans continue to incur a higher risk weight than housing loans for capital adequacy purposes, and while the bigger banks are allowed to use internal risk models to further reduce the risk weighting of housing loans, there remains a high risk to the flow of bank lending to SMEs should a new financial crisis occur.

Equity funding for SMEs is also highly susceptible to shocks to the financial system. In any financial crisis, equity will be difficult to raise, particularly through the stock market which is highly dependent on broad-based investor confidence.

In AVCAL's view, the greatest prospect for building greater stability in the equity capital pipeline is if a deep investor base in PE and VC funds is developed in Australia.

It should be noted that even during the lowest point of the global financial crisis, in FY2009, PE and VC funds still invested $2.5b in Australian businesses: more than the $1.1b raised in IPOs on the ASX that year.

Table 2: Financing options for Traditional SMEs vs Innovative/Disruptive Startups & SMEs

Source of financing	Traditional established less-innovative/less-disruptive SMEs	Innovative/disruptive startups & SMEs
Banks	Loans secured on tangible collateral and serviced from net revenues (revenues minus expenses): some (not all) will pass credit scoring models.	Limited collateral (assets are IP, essentially intangible) and negative cashflows (though with high cashflow projections): likely to fail credit scoring model criteria.
VC and PE funds	Focus mainly on companies with high growth or turnaround potential.	Equity funding based on rigorous assessment of potential, with hands-on, strong oversight of operations.
P2P platforms and crowdfunding	Likely small amounts of crowd-based funding with regulation still being developed. Likely to require high expected rates of return to attract lenders/investors.	Likely small amounts of crowd-based funding with regulation still being developed. Likely to requires high expected rates of return to attract lenders/investors.

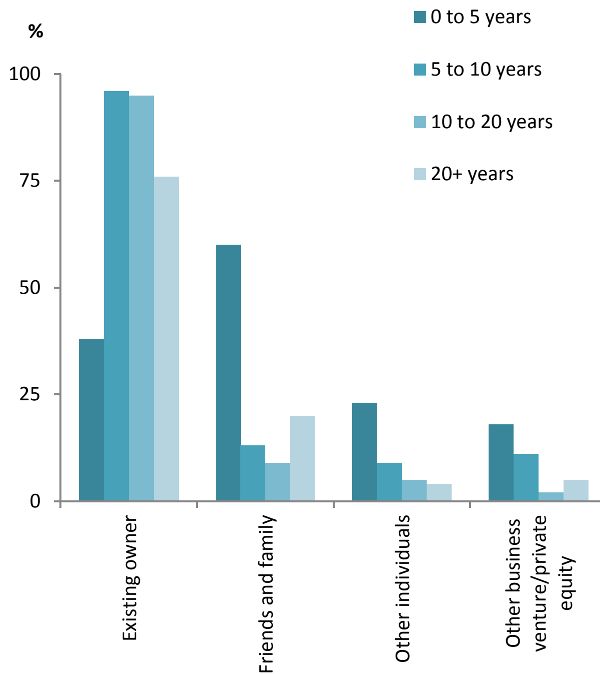
1.1.5. Role of PE and VC in addressing SME challenges in accessing finance

Australia has, it is estimated, around 30,000 businesses which fall within the PE 'investment range' (i.e. businesses that have growth potential and which are likely to require significant capital injections to realise that potential) (see Figure 2).

Many of those businesses will, at some point in the medium-term, seek investors for a variety of reasons such as succession planning, expansion capital, and turnaround financing.

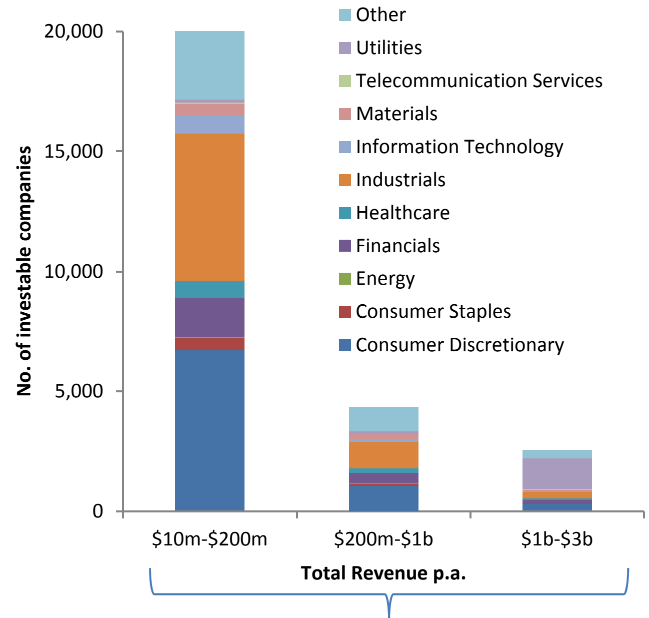
PE funds are currently invested in fewer than 350 businesses in Australia: meaning that they presently have the funding capacity to financially back less than 2% of the total 'investable pool' of up to 30,000 businesses.

Figure 1: Sources of External Equity Finance by Firm Age in 2005



Source: ABS Longtitudinal Database

Figure 2: Pool of potentially investable businesses in Australia



PE is currently invested in around 350 companies that generate an estimated $63b revenues p.a.: comprising only 1.4% of the pool of potentially investable businesses.

Sources: S&P Capital IQ, Deloitte Access Economics, AVCAL. Based on Total Revenues as of the end of the most recent reporting year as of 1 Mar 2014. For all Australian-headquartered businesses with Total Revenues between $10m to $3b. Excludes companies in Oil & Gas, Metals & Mining, Forest Products, Real Estate & Construction, Primary Food Products, Tobacco and Banks.

1.2. Addressing barriers to the growth of VC

1.2.1. Transparency of PE and VC fees

The Report recognises that, "unlike other fund managers, venture capital fund managers are typically very involved in managing the ventures in their funds. Venture capital fund managers provide mentoring services, business expertise, and access to industry and market connections, which is reflected in management and monitoring costs."

However, the report also suggests that fee structures and the services these fees reflect may not always be transparent to investors, and that greater transparency would allow investors in PE and VC to make more informed investment choices and lead to greater competition.

AVCAL response:

Fee structures and reporting are agreed on between the investors and the PE or VC fund. When an investor makes a commitment to a PE or VC fund, the resulting 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, these fees are typically broken down in detail to indicate how much was paid in management and performance fees, and any offsets against those fees.

Feedback from AVCAL members – both PE and VC fund managers, as well as their investors – indicate few, if any, concerns relating to a need for more fee transparency, and general

satisfaction with the level of fee disclosure and transparency provided by Australian PE and VC fund managers to their investors.

If a first-time manager is not deemed to be disclosing sufficient fee detail in its quarterly reports, this is in most cases resolved promptly with a follow-up information request, so that all parties are clear on investors' information expectations. All AVCAL members are encouraged to comply with the association's reporting guidelines, which includes minimum standards on fee disclosures.

It is possible, however, that investors who are a step removed from the detailed reporting obligations of PE and VC funds to their investors may not be aware of the details behind PE and VC fee structures. Such investors may include the end-beneficiaries of widely held portfolios that include PE and VC investments.

AVCAL fully supports efforts to help investors make more informed investment choices, and to promote broader awareness of how PE and VC help provide SMEs in particular with greater access to equity capital as an alternative to bank lending. AVCAL has been active in promoting greater public education in this regard, through introductory seminars (available to the public) on how industry operates, as well as factsheets on industry fee structures and how they work in practice.

It should be noted, however, that such efforts are unlikely to result in "greater competition" for institutional capital, if the assumption is that competition will drive fees significantly lower. The reality is that competition for institutional capital – particularly among managers of illiquid investments, who have to access a much more limited pool of capital allocations compared to managers of more liquid investments – is already extremely high.

Promoting greater public awareness of the fee structures to facilitate informed investment is a positive step, but unlikely to trigger heightened fee-based competition as envisaged in the Report.

How PE and VC management fees work

Typically, management fees are set at between 1.5-2% of the investor's commitments to the fund. This means that for a fund size of $100m, the management fees will be between $1.5m-$2m which pays staff salaries, overheads and other costs of running the fund.

The management agreement usually stipulates that the investors of the fund receive fee credits/offsets against any fee revenues earned by the fund or its managers in the course of carrying out the fund's investment mandate. These may include offsets for deal arrangement fees, portfolio advisory fees, transaction and directorship/monitoring fees, and broken deal fees. This usually results in net management fees paid by the investor being lower than the 1.5-2% rate over the course of the fund's life.

This fixed base fee structure generally works in the investor's favour, as it means that the investor pays a set fee for value-adding management services rather than an asset-based fee for simply buying and holding assets while market values rise.

PE and VC funds are typically closed-end with a finite life of around ten years. After the investment phase of the fund – usually the first five to six years of the fund – the fund enters a fee step-down phase where the base fee progressively reduces over the remaining years of the fund's life. This again works out in the investor's favour, as the investor actually pays less in management fees as the fund matures. This feature is included in the fee structure as it recognises that the fund manager's workload typically reduces as the fund begins progressively exiting investments to realise returns for its investors.

How PE and VC performance fees work

The investment managers receive performance fees in the event that the investors in the fund achieve cumulative investment returns in excess of a specified rate. Performance fees are typically set at 20% of the fund's proceeds, and are only triggered if the fund meets its "preferred return", i.e. a predetermined rate of return above the market benchmark. 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.

The fee structure of a 2% management fee and 20% performance fee is often called the "2-and-20" structure.

It should be noted, however, that before the managers can receive a performance fee, they 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 not a permanent expense which reduces the investors' returns, but rather an advance to the manager which must be repaid. This structure effectively reduces the total fees paid by investors to a "2-or-20" structure.

These types of performance fee structures help align the interests of fund managers and investors with the objective to achieve the best possible net returns from invested capital.

However, 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.

Institutional investors with experience in the asset class generally recognise that there are limits to which it is viable to run, at low cost, a PE or VC fund with a high calibre team that performs highly resource-intensive work.

For example, a US GAO report on the challenges faced by defined benefit pension plans when investing in PE found that, *"Despite these [higher] fee structures, pension plan officials we contacted cited attaining returns superior to those attained in the stock market as a reason for investing in hedge funds and private equity"*.[4]

A 2012 Hamilton Lane study on institutional investors' PE portfolios cited one CIO's view on this: *"I pay my public equity managers 40 basis points and in return they produce 50 basis points outperformance over the S&P, over the long term. If I expect my private money managers to produce over four times that, or 200 to 300 basis points outperformance, then I should be willing to pay more. They do. Looking back, my managers have produced 800 basis points outperformance, net of fees".*[5] The study also noted the additional benefit of the PE fee structure where most are structured to pay the management fee back before earning the performance incentive.

The Report has identified noted some of the core value-adding aspects of PE and VC ownership, such as mentoring, sharing their business expertise, and providing their investees with access to industry and market connections.

Often, the investment team will have specialised areas of expertise which makes their skills sets particularly valuable in helping to unlock value in fast-growing companies, such as technology-centric ventures. These collective qualities and experience, and their value to investees, cannot be easily replicated at low cost.

1.2.2. Removing roadblocks to superannuation investment in VC

The Report states that there are "very few impediments" to superannuation funds wishing to invest in VC and that "superannuation funds could consider investing in venture capital funds as part of a broader approach to diversifying their asset portfolios. This may involve taking a broader view of their investment options and require them to engage the required expertise."

AVCAL response:
While there are no bright-line rules restricting superannuation funds from investing in VC, there are a number of significant regulatory and structural roadblocks that deter superannuation investment in unlisted asset classes such as VC. The following are common reasons for the decline in investment by superannuation funds into local VC funds:

[4] US Government Accountability Office, *Defined Benefit Pension Plans: Plans Face Challenges When Investing in Hedge Funds and Private Equity*, 31 Aug 2011.

[5] Blackburn, T. and M.Augustine, *Private Equity Performance: Worth The Wait*, Hamilton Lane, April 2012.

- Under the recently introduced *Stronger Super* reforms, trustees are obligated to consider scale as part of their investment strategy and decisions. With the rapid growth of superannuation funds in recent years, investments in Australian VC funds are now generally considered "too small" for large institutional super funds to invest in. In 2004, the average super fund's mandate size was $65m.[6] By comparison, the largest domestic VC funds are only around $200m while most are around $50m.[7] In 2011 AustralianSuper's (the largest domestic superannuation fund) average mandate size was reported to be $235m.[8] For efficiency, large global institutional investors will often not even consider investing in individual funds that are smaller than $1b, even if there are smaller funds offering exceptional value.
- In addition, early stage VC investments are now often considered too high-risk for most superannuation investors.

These challenges are neither insubstantial nor unique to Australia. To address this, in most other developed markets programmes to encourage VC investment have become a core part of national economic policy. Government co-investment programmes in particular have been recognised as a particularly powerful lever in attracting both local and international institutional investors in early stage ventures.

The case for Government co-investment in VC funds to help stimulate investment in SMEs has been widely accepted as a long term strategic policy imperative in many countries, despite many facing challenging budgetary conditions.

Examples of such co-investment programmes include the New Zealand Venture Investment Fund (NZVIF), Singapore's Early Stage Venture Fund (ESVF) scheme, Israel's Yozma programme, the US Small Business Administration's US$1b Early Stage Innovation Fund under President Obama's Startup America initiative, and Canada's Venture Capital Action Plan announced in 2013.

In AVCAL's view one of the most effective steps to encourage private investment in VC and innovative early stage companies would be the introduction of a new innovation policy that incorporates a Government-seeded translational innovation fund that co-invests alongside private investors (such as superannuation funds) in venture funds that invest in Australia.

The risk and profit sharing structures could be set up to incentivise private sector investment without any significant fiscal impact to the Government.[9] Similar structures have worked successfully in the past, for example the Innovation Investment Fund programme which helped provide early funding to companies such as SEEK when they were in their startup phase.

NZVIF case study

The New Zealand Venture Investment Fund (NZVIF) was established by the New Zealand Government in 2002 to help build a vibrant VC market in the country.

In the process of setting up NZVIF, the question of whether it was appropriate for a Crown-owned company to be involved in VC investment was carefully considered. The New Zealand Government ultimately took a decision that growth in this investment sector was an important part of increasing the available capital to young innovative New Zealand companies to enable them to grow and reach their potential.

NZVIF was established "because the venture capital market in New Zealand has been of a negligible size for many years. What New Zealand is doing is commonplace around the world, where many countries have seen the need for government investment to act as a catalyst in the development of venture capital markets".[10]

To allow for independence and continuity, NZVIF was set up to operate as a private

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[6] Bateman, H. and S. Thorp, *Decentralised investment management 0 an analysis of nonprofit pension funds*, Centre for Pensions and Superannuation, UNSW, Working Paper 04/2006.
[7] Institutional investors also generally impose their own exposure limits to how much they can invest in any single fund. For example, they may have an internal policy of not committing to more than 30% of any single investment fund.
[8] Financial Standard, *Bentham wins $350 million mandate*, 27 May 2011.

[9] More details available in AVCAL's submission to the Senate Inquiry on Australia's Innovation System: http://www.avcal.com.au/avcalnews/submission-senate-inquiry-into-australias-innovation-system
[10] http://www.nzvif.com/venture-capital-faq.html#is-it-appropriate

investment business, developing and managing products for the early stage and VC investment markets. It operates as a fund-of-fund, governed by a private sector board of directors who have oversight of an investment management team that invests into VC funds (and also partners with angel investor groups) to drive investment into young New Zealand companies with high growth potential.

As an investor, NZVIF invests in line with industry standard terms. As with other normal investors in VC funds, it takes an active role in monitoring fund activity and tracking investment performance.

NZVIF currently has NZ$200m under management, and has backed companies such as Xero, the cloud-based accounting software company.

As of end-2013, over 160 companies have received investment from NZVIF, and the tax paid back by these companies to the New Zealand Government now exceeds the amount invested.[11]

1.2.3. *Simplify the tax treatment of VCLPs*

The report states that "the tax treatment of Venture Capital Limited Partnerships (VCLPs) is complex and may be a barrier to fundraising". It notes the Board of Taxation's Review into VCLPs which made recommendations to simplify and reduce uncertainty, which would reduce barriers to investment.

The Inquiry sought further information on the following:

- What are the best options for improving the tax treatment of VCLPs?

AVCAL response:
In AVCAL's view, one of the most significant measures that can be taken to encourage investment in VC and PE in Australia would be to introduce the tax reforms recommended by the Board of Taxation in its review of VCLPs in 2011.[12]

The VCLP and Early Stage Venture Capital Limited Partnership (ESVCLP) programmes were introduced in 2002 with the following policy objectives:

- to provide Australia with “a world's best practice investment vehicle for venture capital”;
- to encourage new foreign investment into the Australian VC market;
- to attract VC to support the growth of niche or emerging state-of-the-art research and development;
- to address a perceived market failure to attract capital investment to high risk and expanding businesses; and
- to fund the growth of expanding Australian business to facilitate economic growth and job creation, including to encourage high calibre VC managers to move into the sector.

Table 3: Number of VCLPs by year of formation

Year	No. of new VCLPs
2004	3
2005	5
2006	6
2007	10
2008	2
2009	2
2010	1
2011	6
2012	2
2013*	3
2014*	2
Unknown*	1
Total	**43**

* Includes conditionally-registered VCLPs
Sources: Innovation Australia, Department of Industry, AVCAL

[11] NZVIF CEO Francesca Banga, interview on Radio New Zealand's Nine to Noon, 28 Nov 2013.

[12] The Board of Taxation, *Review of taxation arrangements under the Venture Capital Limited Partnership Regime*, June 2011.

Table 4: VCLP investments made in 2012-13, by total assets

		No. of VCLP invest-ees 2012-13	VCLP Invest-ment 2012-13 ($m)
Small	<=$500k	15	13.2
	>500k<=$1m	9	4.97
	>$1m<=$5m	20	28.36
Medium	>$5m<=$10m	5	7.48
	>$10m<=$25m	7	33.29
	>$25m<=$50m	2	14.94
Large	>$50m	7	116.14
Total		**65**	**218.38**

Sources: Innovation Australia, Department of Industry

Table 5: Number and value of VCLP investments in 2012-13, by sector

Sector	No. of VCLP investe es 2012-13	VCLP Investment 2012-13 ($m)
Health Care and Social Assistance	21	44.68
Information Media & Telecommunications	27	26.82
Manufacturing	4	30.18
Mining	4	42.61
Rental, Hiring & Real Estate Services	2	22
Retail Trade	2	7.12
Transport, Postal and Warehousing	2	38.21
Other Services	3	6.76
Total	**65**	**218.38**

Source: Innovation Australia, Department of Industry

Since the program's inception, $2.8b has been invested by VCLP in eligible Australian businesses, including $251m invested in 61 businesses during 2013-14.

At 30 June 2014, there were 43 registered VCLPs (including four conditionally registered) with approximately $5.4b in committed capital, of which 41% is sourced from overseas investors.

In recent years the ability to successfully raise new funds using the VCLP structure has been severely challenged due to uncertainty over the tax treatment of different classes of domestic and offshore investors into VCLPs (Table 3).

As the legislation currently stands, foreign investors have certainty in respect of capital account tax treatment, but a similar level of certainty does not currently exist for all domestic investors.

Minor legislative reform is needed to remove this uncertainty for investors by clarifying that gains from investments through these vehicles would be classified on capital account for all eligible domestic investors. This was also recommended by the Board of Taxation (BoT) in its 2011 review into the taxation arrangements under the VCLP regime.

Feedback from AVCAL members has consistently highlighted that the present capital/revenue account tax uncertainty is the issue of greatest concern within the VCLP regime, and a significant impediment to domestic fundraising.

In AVCAL's assessment, further investment into startups and SMEs is being held back as a direct result of the current inconsistency in the tax rules that apply to different classes of domestic investors in VCLPs.

The current uncertainty over the tax treatment of VCLP investors is counterproductive to the policy intent the regime.

Addressing this uncertainty without any further delay will help remove what has been a significant roadblock to the domestic VC and PE industry in its efforts to raise capital from the private sector.

AVCAL is of the view that the Government should implement the Board of Taxation's recommended reforms with regard to VCLPs as soon as possible, namely:

- Deemed capital account treatment should apply to eligible domestic partners on gains or profits made by a VCLP on the disposal of eligible investments, and eligible domestic partners should be defined in a way that is consistent with the definition of eligible foreign partners. The Board of Taxation has noted that, "This reduces uncertainty in the tax treatment of domestic limited partners and it is likely to lead to greater investment in VCLPs. Domestic investors are an important source of capital for the development and growth of the Australian venture capital sector".
- An Australian managed investment trust (MIT) should be able to invest as a limited partner in a VCLP and retain its MIT status.
- The restriction on investment levels for foreign venture capital fund of funds should be removed provided the fund is widely held.

For ESVCLPs, AVCAL believes that the Board of Taxation's recommendations should also be implemented as soon as possible, namely:

- An investee entity should have greater flexibility to invest in other complementary ventures, provided the investee acquires a controlling stake in the venture and the venture is otherwise an eligible investment.
- The holding company exception should be modified to allow an ESVCLP to invest in a holding company which has existing interests in multiple subsidiaries, as long as those subsidiaries satisfy the eligible venture capital investment requirements.
- The 20% restriction on the level of expansion into foreign markets and direct foreign investments should be clarified and Innovation Australia (or another responsible representative or department within the Department of Industry if deemed appropriate) should have discretion to allow ESVCLPs to exceed the cap on foreign investment provided the investment is likely to have material national benefit.
- An Australian MIT should be able to invest as a limited partner in an ESVCLP and retain its MIT status. To this extent, an exception to Division 6C should be provided.
- Where a limited partner in an ESVCLP is a trust (that is not taxed as a corporate) the investors in that trust should not be prevented from accessing the special tax treatment accorded under the ESVCLP regime. That is, the exemption should not be clawed back through the operation of CGT event E4.

In addition, for more efficient administration of both VCLPs and ESVCLPs, Innovation Australia (or another responsible representative or department within the Department of Industry if deemed appropriate) should have the power to give binding advice in relation to the definition of ineligible activities.

To the best of our understanding, AVCAL does not believe that the implementation of these reforms would carry a significant revenue cost to the federal budget position.[13] The Treasurer in November 2013 classified these measures as "minor changes to the tax arrangements for venture capital investment", which would indicate that the resources needed to introduce these changes are small relative to the clear benefits they offer.[14]

A consistent and clearly defined VCLP tax regime will give investors the certainty they require to commit private capital towards private Australian businesses. Such investment will greatly support the broader innovation agenda by encouraging private domestic investors to invest in unlisted Australian startups and SMEs with high growth potential.

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[13] Any perceived risk to the revenue associated with AVCAL's recommendations should be more than offset by increased taxation receipts from bigger and more profitable portfolio companies, and more productive workforces. The assessment of the Deputy Governor of the RBA, Mr Battellino, noted in the Senate Report on the review of private equity in 2007, was that: "[the] conclusion would be that really on a macro scale shifts in the patterns of financing probably do not have a big overall impact on the tax base."

[14] The Hon Joe Hockey MP, *Restoring integrity in the Australian tax system*, joint media release with Senator the Hon. Arthur Sinodinos AO Assistant Treasurer.

1.2.4. *Improve access to R&D quarterly tax credits by new ventures*

The Report noted that for new ventures, access to quarterly R&D tax credits would help alleviate cash flow constraints, and suggested that this issue be considered as part of the Tax White Paper process.

AVCAL response:

Early stage companies involved in developing new technologies often face cash-flow constraints because they require significant cash outlays in the early stages of the product life cycle.

Currently, these companies can access a 45% rebate on expenditure related to eligible research and development (R&D). The R&D tax regime has had a very significant positive impact in supporting domestic businesses investing in innovation.

It is also an important incentive for offshore investors to put money into Australian companies, and in attracting businesses from offshore to re-locate their R&D operations to Australia. This plays an important role in helping businesses to source adequate levels of capital investment in the knowledge that the regime will deliver long-term certainty to businesses that commit large allocations towards R&D activities.

In some cases, however, accessing the support that can be delivered by the existing R&D regime can effectively be delayed by up to 16 months, as businesses are typically required to wait until the point in time that they lodge their income tax return for the financial year, and then wait a further four months to secure the R&D rebate that they may be eligible for.

In a practical sense, companies seeking to commercialise patents can miss out on the opportunity to derive premium earnings and returns on investment during the exclusive earning period for new patents.

AVCAL supports a move to quarterly R&D tax credits to alleviate the cash-flow constraints that these companies face. The businesses that would gain the most out of this change are small, research-intensive enterprises with annual turnover under $20 million. These businesses typically have limited access to capital, but the R&D tax credit has been one measure that has been widely supported by those small businesses that invest heavily in R&D activities.

The fiscal impact on the federal budget would appear to relate mostly to timing differences, and concerns regarding over or underpayment of credits can be addressed in much the same way as for quarterly GST or PAYG income tax payments.

While there is a perceived risk in relation to the difficulty of clawing back overpayment of credits due to the risk profile of these early stage companies, integrity rules similar to those used for the GST and income tax can be put in place to mitigate the risk. More generally, the risk profile of these companies is not dissimilar to many other SMEs, which are a vital part of the Australian business landscape.

In a global marketplace for capital and R&D investment, it is critically important to position Australia as an innovative 21st century economy and a ‘knowledge nation’. Australia must continue to improve its policy settings in the R&D area, to ensure that we can continue to compete with other jurisdictions around the world.

AVCAL does not believe that there is a significant fiscal cost associated with the introduction of these reforms to the R&D tax credit regime, but there will almost certainly be a very real and positive impact on the working capital of small innovative companies in Australia.

1.3. Crowd-sourced equity funding

The Report noted that for mid-caps, the cost of issuing equity can be prohibitive. It also noted the CAMAC report on crowdfunding, and that this report is currently being reviewed by the Government.

The Inquiry sought further information on the following areas:

- Is there a need to introduce differentiated markets to allow greater access to equity markets by smaller companies?
- Should other capital-raising requirements be modified to reduce dilution effects? Would this affect the capacity of corporates to raise funds, particularly under conditions of market stress?

AVCAL response:

AVCAL supports the key policy directions set out in the CAMAC report. With other developed economies already taking the lead in setting out policy frameworks to support crowd-sourced equity funding, Australia will need to keep abreast with global developments in this regard or risk falling behind in the global competition for early stage entrepreneurial talent and capital.

AVCAL believes that Australia should remove unnecessary roadblocks to crowd-sourced equity funding in Australia, but at the same time ensure there are appropriate safeguards for investors who might not have significant experience investing in high-risk ventures.

Measures suggested in the CAMAC report such as establishing a new exempt public company structure to facilitate equity crowdfunding, and an investor cap of $2,500 per annum per individual investor, have their merits but require further consultation with industry and potential investors with regard to their costs, uses and ultimate feasibility.

One question which requires further consideration is: who are the anticipated investors, and where is the majority of the ‘crowd-funded’ capital expected to come from? If they are primarily retail investors, a low investment cap such as $2,500 may be appropriate, but this may also mean that there is more speculative and uninformed investment. If they are primarily knowledgeable and sophisticated investors, a $2,500 investment cap may be counterproductive, as these are likely to be the types of investors that would not only be sought after by startups but also have larger pools of investable capital (including high net worth investors).

To better inform decision making, the CAMAC statement that "restricting the pool of potential [retail] investors in this manner may not allow for a meaningful level of capital to be raised through CSEF in many instances" (p.17) should be further explored, as it is currently unclear if the majority of (profitable) investment would indeed be raised through a broad base of retail investors rather than through sophisticated investors.

Potential issuers and investors also need to be made aware of their respective rights, obligations and risks. For instance, most companies seeking crowd-sourced equity funding will likely be newly-emerging businesses, which will almost certainly need to raise more capital in the future if they are successful.

However, it may not be easy for an equity ‘crowd-funded’ company to get future funding from angels, VC or PE funds or corporate investors if the original shareholders’ agreement (or lack thereof) does not facilitate certain controlling rights being passed on to the new financial sponsor(s), and if there is already a very large and diverse shareholder base which may make it difficult for the new financial sponsor(s) to exercise its investment strategy.

Therefore, it is important for issuers to take the appropriate steps to ensure their legal and tax structures are set up to mitigate the risks of being deemed "unfundable" by potential future investors.

Nevertheless, it is also important that the crowd-sourced equity funding legal framework does not add new layers of administrative complexity which leads to a significant cost burden for startups wishing to access capital this way. Achieving a balance between flexibility and consumer protection will be critical to the effectiveness of the new regime.

1.4. Reduce the complexity and cost of external administration for businesses

The Report discussed suggestions that Australia should adopt the US Chapter 11 regime, or certain aspects of it.

The Inquiry sought views on the costs, benefits and trade-offs of the following policy options or other alternatives:

- No change to current arrangements.
- Implement the 2012 proposals to reduce the complexity and cost of external administration for SMEs.

The Inquiry sought further information on the following area:

- Is there evidence that Australia's external administration regime causes otherwise viable businesses to fail and, if so, what could be done to address this?

AVCAL response:

As the Report points out, a well-functioning external administration regime facilitates the efficient recycling of capital, and therefore contributes to the efficiency with which funds are allocated across the economy. It also protects creditors' rights, which promotes confidence in broader credit provision.

AVCAL welcomes the Inquiry's work in seeking policy solutions to reduce the complexity and cost of external administration for businesses.

It is noted that the Inquiry considers that "*Chapter 11 has rarely enabled businesses to continue as going concerns in the long term*".

AVCAL is of the view that the Inquiry should consider aspects of the Chapter 11 regime that are intended to help maximise the chances of the business continuing as a going concern.

This recognises the fundamental principle that it can be more economically efficient for a business to be sold as a going concern, or at least allowed time to reorganise and cancel some of its debts, rather than if the business's assets were to be forcibly sold off individually under voluntary administration.

One example of an aspect of the US Chapter 11 regime that should be considered, for example, is the US prohibition against the termination of supply agreements when the only grounds for termination are that the company is entering Chapter 11, even if the company is able to pay those suppliers as long as it remains a going concern. The Corporations Act has no such protection for the business, which makes the business more vulnerable to contract terminations that hasten severe financial hardship or collapse.

AVCAL believes that the Inquiry should consider elements such as these, as part of the broader objective of allowing distressed companies to have more options in turning around their operations in a cost-effective and less disruptive manner.

2. SUPERANNUATION

2.1. Fee competition and net returns

The Report observed that "there is little evidence of strong fee-based competition in the superannuation sector, and operating costs and fees appear high by international standards. This indicates there is scope for greater efficiencies in the superannuation system".

It noted that while it is too early to observe effects of MySuper, but perhaps other mechanisms could be employed in the meantime to drive costs further down, such as the Chilean single default fund model, with default fund auctioned off on the basis of fees.

The Inquiry sought views on the following policy options or other alternatives:

- No change to current arrangements and review the effectiveness of the MySuper regime in due course.
- Consider additional mechanisms to MySuper to achieve better results for members, including auctions for default fund status.

The Inquiry sought further information on the following:

- Does, or will, MySuper provide sufficient competitive pressures to ensure future economies of scale will be reflected in higher after-fee returns? What are the costs and benefits of auctioning the management rights to default funds principally on the basis of fees for a given asset mix? Are there alternative options?

AVCAL response:

While strong fee competition is absolutely important, AVCAL is of the view that a policy focus on reducing superannuation fees at all costs detracts from the main objective of an effective long-term superannuation framework. If not addressed, this could potentially steer Australia's superannuation policy settings too far in the wrong direction, which would ultimately be to the detriment of future retirement outcomes for all Australians.

2.1.1. Optimal diversified portfolio is not always made up of low-cost assets

In our view, the evidence often cited justifying the focus on reduced fees is inadequate and, in most cases, not tested in the Australian context.

The 2009 Squam Lake Working Group report by a team of US academics (which was cited in the Report as a basis for justifying low-cost default pension options) simply states that "academic research provides compelling evidence that higher fees and expenses reduce the returns to investors. Thus, default investments should include only low-fee, diversified products".[15]

However, it does not provide any citations to support this conclusion or to allow for more informed debate on the issue. In addition, the Squam Lake report merely notes that default funds should be diversified, with fees below 2.5% pa: whereas it should be noted that the current average fee rate for the whole Australian superannuation industry is already at 1.12% of assets.[16]

Similarly, a recent Grattan Institute report's recent assertion that the Australian superannuation system is inefficient as a result of high fees has been widely criticised as unsound for its flawed analysis comparing Australia's system with international counterparts.[17]

Any fees and costs that drag down the member's superannuation balance, without significant value-add for the fund member, should of course be considered an unproductive fee. However, there is as yet no evidence that all

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[15] Council on Foreign Relations, *Regulation of Retirement Saving*, Working Paper, Squam Lake Working Group on Financial Regulation, 2009.
[16] Rice Warner, FSC Superannuation Fees Report 2013.
[17] See, for example, Herbert Smith Freehills' *Submission to the Financial System Inquiry*, 14 Aug 2014.

fees charged across all asset classes are universally 'unproductive'.

However, there is a strong body of evidence, which is all supported by market experience, from global pension funds that some asset classes that may not be considered "low-fee" should be considered an integral part of an optimal retirement portfolio, due to the significant positive impact they can have on long-term retirement outcomes. Below are some examples:

- The Defined Contribution Institutional Investment Association states that it "believes that DC plan sponsors should consider adding an investment offering that provides better risk balance, in an attempt to enhance returns and to reduce the volatility that the typical plan participant experiences… DC plan sponsors could incorporate alternative investment strategies and best practices used by DB plans, potentially helping to close the performance gap that has long existed between the two plan types." [18]
- Most mature pension PE programmes provide strong evidence of the value in taking a long-term view of the asset class. For instance, the California Public Employees' Retirement System (CalPERS) – the US's largest public pension fund – had 14% of its assets in PE in 2012. As of end-2012, CalPERS' PE programme had generated US$23b in profits since 1990 for its members, and had an annualised 10-year return of 6.86% compared to 2.92% on its public equities portfolio.
- The Future Fund, set up to help to meet the Commonwealth Government's unfunded superannuation liabilities, has grown its PE allocation from 0.002% of total assets in 2008 to 6.8% in 2013 (still short of its target allocation of 8%) in order to: (i) invest in high 'alpha' opportunities; and (ii) gain exposure to investment themes that cannot be readily gained through more liquid investments, such as VC, distressed opportunities, and funding idiosyncratic growth in small companies (growth equity).[19]
- It is also instructive to evaluate the opportunity cost of not investing in high-fee asset classes that may deliver value far in excess of their costs. In a memo to its Board in 2011, the Montana Public Employees' Retirement System (MPERS) noted that if MPERS had allocated each PE drawdown since 1994 to its domestic stock portfolio instead, the fund would have been US$221m poorer by 2010: equivalent to 7% of the fund's $3b assets under management at the time.[20] This suggests that a Montana public employee who accumulated $500,000 in her pension over that period would have had only $465,000 if the fund had invested its PE allocation in the domestic stock portfolio instead.

2.1.2. Ultimate objective of super is adequate retirement income

AVCAL agrees with the superannuation industry's overarching view that there is an urgent need for political and industry consensus on the long-term objectives of superannuation.

More than simply being a forced savings vehicle for workers, the fundamental public policy objective of super should be to reduce reliance on the age pension in funding the retirement incomes of most Australians.

To achieve this objective would require a robust evaluation of whether current focus on low fees is correctly targeted. Until there is evidence to this effect, the introduction of any new mechanisms such as a new default fund framework to drive costs further down in the meantime is not recommended.

AVCAL recommends that the Inquiry should allow time for the policy objectives of Stronger Super and MySuper to take effect. The early evidence suggests that MySuper costs are already on the decline.[21] Further disruption

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[18] DCIIA, "Is it time to diversify DC risk with alternative investments?", White Paper, May 2013.
[19] Future Fund Annual Report 2011/12.
[20] Memo on "Pension Fund PE Investments" in Montana Board of Investments meeting materials, 14 July 2011. Prospective estimates are based on expected annual arithmetic investment returns for each asset classes as published in the December 2010 Teachers' Retirement System (TRS) Asset/Liability Study conducted by the Montana Board of Investment's consultant.
[21] AIST and Rice Warner, *Navigating the new MySuper landscape,* July 2014.

of the default fund framework at a time when the industry is coming out of several years of significant structural and regulatory change is likely to be unhelpful at this stage, unless the benefits can be shown to outstrip the costs of further change.

2.2. Promoting a long-term focus

The Inquiry sought further information on the following areas:

- Are there net benefits in tailoring asset allocation to members and/or projecting retirement incomes on superannuation statements?
- Is there an undue focus on short-term returns by superannuation funds? If this is a significant issue, how might it be addressed?

AVCAL response:

Statistical reporting by regulators, product disclosures and member statements should be carefully considered so that to the extent possible they encourage members to focus on long-term outcomes.

A substantial amount of regulatory reform has gone into promoting the disclosure of fees and costs, and portfolio holdings. It is widely expected that the public reporting of fund-by-fund fee metrics, together with existing superannuation league tables widely used within the industry, will promote an environment where members increasingly use this data to inform their long-term superannuation choices.

In AVCAL's view, the metric which matters most is the member's account balance at retirement: the account balance made up of net contribution flows and net investment earnings.

AVCAL recommends that the disclosure framework for MySuper should encourage members to focus on their net retirement income, rather than the fees paid per annum.

Product dashboards already require super funds to report long term returns (net of fees and costs). AVCAL believes that focusing members' attention on net returns is more meaningful than focusing on reducing headline fee metrics, which are reported in a manner which draws no link to the net returns figures.

Disclosures that inadvertently encourage members to make choices based on fees without due regard to net returns would be counterproductive.

A more meaningful metric to focus on – consistent with the fundamental objectives of superannuation – would be to report regularly to the member his or her projected account balance at retirement, and projected retirement income stream.

Current required disclosures of fees and costs should be reviewed in consultation with the broader investment community. 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, as explained in Section 1.2.1, 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 or Management Expense Ratio.

2.3. Passive vs active asset management

The Inquiry sought further information on the following area:

- To what extent is there a trend away from active asset management within asset classes in superannuation funds? Is this a positive or negative development for members?

AVCAL response:

The Report links active investment management to short-termism and high rates of transaction activity, which in turn intensifies the transaction costs passed on to superannuation investors. It notes that, *"Many funds adopt active management of superannuation assets in the pursuit of higher returns. Active management can often involve frequent adjustment to the investment portfolio in an attempt to outperform the market, particularly over shorter horizons. However, the costs of active management, including transaction costs and management fees, are widely acknowledged."*

It should be noted that active management does not always mean high turnover (resulting in added transaction fees). AVCAL is of the view that PE and VC funds, while constituting "active management" in the sense that they aim to outperform passively managed funds, do not buy and sell investments on a frequent basis. PE and VC funds have a typical lifespan of ten years, and within that period practise buy-and-hold investing with an average holding period of 5 years per investment (with most funds invested in around 10 businesses when fully invested).

This contrasts sharply with the 77% of ASX investors who churn their shares within 5 years or less (of which 17% churn their shares within a year or less).[22]

There is limited evidence so far on whether the current policy framework for MySuper is set up to produce optimal long-run after-fee returns.

The Report appears to accept that competitive pressure on fees is sufficient to result in higher after-fee returns. However, this may be misdirected, given that the current regulatory framework intrinsically discourages optimal portfolio asset allocation (which would include exposure to active management strategies delivering a higher net return) in favour of a bias towards low-cost liquid assets (which would not be expected to deliver a net return anywhere near the same level as a more "optimal" portfolio).

A recent study by the Centre for Finance and Regulation found that the main changes associated with the introduction of MySuper included:[23]

- The emergence of lifecycle products, which was viewed as "probably a net positive by helping to address sequencing risk; but there is an associated cost of lower expected balances at retirement"
- Retail providers reduced fees in their products through lower margins, increased use of passive management, and <u>decreased use of alternative assets</u>, and by introducing more passively-managed products with much lower fees.

In short, the net impact of MySuper is estimated to largely depend on whether default fund members will benefit from the mix of fee reductions and increased passive management, at the expense of active management.

The argument for low-cost passive management versus higher-cost active management is much more contested than the Report would suggest.

[22] ASX 2012 Share Ownership Study.

[23] Chant, W., M. Mohankumar and G. Warren, *MySuper: A New Landscape for Default Superannuation Funds*, Centre for International Finance and Regulation Working Paper No. 020/2014.

Table 6: Cambridge Associates Australia Index Returns for the period ending 31 December 2013

Index (A$)	1-Year	3-Year	5-Year	10-Year	15-Year
Cambridge Associates LLC Australia Private Equity & Venture Capital Index (A$)[1]		**11.56**	**9.89**	**10.03**	**10.87**
PE and VC Index: Top Two Quartiles (A$)	**25.88**	**15.62**	**14.34**	**14.16**	**17.33**
S&P/ASX 300 Index	19.68	8.46	12.33	9.49	9.02

The Cambridge Associates LLC indices are an end-to-end calculation based on data compiled from 64 Australia private equity and 25 Australia venture capital funds, including fully liquidated partnerships, formed between 1997 and 2013. All S&P index returns are based on Accumulation Index returns. All returns are reported on an annualised basis.
[1] Pooled end-to-end return, net of fees, expenses, and carried interest.
Sources: Cambridge Associates LLC, Bloomberg L.P., Standard & Poor's, Thomson Reuters Datastream, UBS AG and UBS Global Asset Management.

Chant et al (2014) provides a useful synopsis of the current debate on the issue: "*Some will argue that members are better off in passive based on (largely US-based) evidence that the average active manager doesn't generate alpha after fees. Others will contend that it is possible for a well-selected portfolio of active managers to outperform at wholesale feel levels, and that US-based evidence need not translate to other markets like Australia. Similarly, lowering exposure to alternative assets involves trade-offs. It limits portfolio diversification. On the other hand, alternatives carry exposure to illiquidity; and it can be debated whether any add-value in alternatives merely accrues to managers in the form of fees*".[24]

The authors go even further to assert that, "*For the record, it is Chant West's opinion that members in retail funds are worse off as a consequence of these changes. Chant West bases this view on two notions. First, that active management adds value when evaluated at wholesale investment management fees, noting that active managers have been comparatively successful in the Australian equity market. Second, Chant West believes that alternative assets are beneficial to members by virtue of the diversification that they bring.*"

Studies by APRA researchers (Cummings and Ellis, 2011), Gottschalg (2010), Robinson and Sensoy (2011), Harris, Jenkinson and Kaplan (2012), Higson and Stucke (2012), Phalippou (2012) and Acharya, Gottschalg, Hahn and Kehoe (2013) have consistently found that illiquid and PE investments specifically have generally produced superior net returns to passive benchmarks, particularly in the long term.

Independent benchmarks show that Australian PE and VC funds collectively (i.e. including both well- and poorly-performing funds) outperformed the S&P/ASX 300 Index by 185 basis points per annum over the fifteen years ending 2013 on a net-of-fee basis. This outperformance becomes even more marked if investors are skilled enough to pick the top 50% new funds to invest in every year: the net-of-fee outperformance then rises to 831 basis points per annum.

[24] Ibid.

3. INTERNATIONAL INTEGRATION

3.1. Tax treatment of managed funds

Submissions received by the Inquiry suggest that some tax settings in Australia distort international financial flows and restrict financial integration. Many of these issues have been raised before as part of the Johnson, Henry and Board of Taxation reviews.

The Inquiry sought further information on the following areas:

- What are the potential impediments to integration, particularly their relative importance, and the benefits to the broader Australian economy that can be demonstrated if they were removed?
- Where is future Government engagement needed to facilitate integration with Asia?

AVCAL response:

AVCAL supports the full implementation of the Johnson Report recommendation relating to the introduction of an Investment Manager Regime (IMR). It is in full agreement with the conclusion in the Johnson Report, that if Australia had access to a broader set of appropriate vehicles to sell into Asia that were taxed on a flow-through basis, then more collective funds vehicles would be managed and administered out of Australia.

It should also be noted that the Board of Taxation's review of the tax arrangements applying to Collective Investment Vehicles (CIVs) was completed in December 2011 but the report, and the Government's response, has to date not yet been released. The considerable delay between reporting and public release was a concern pointed to in Parliament by the current Government, when in Opposition, in March 2013.[25]

The outcomes of this review are important because the CIV of choice domestically, apart from VCLPs, remains a managed investment scheme taking the legal form of a trust. Currently some features of Managed Investment Trust (MIT) tax framework put Australia's funds management sector at a competitive disadvantage in terms of managing funds for offshore clients who have greater certainty of flow-through tax treatment through other international CIVs of choice such as limited partnerships and limited liability companies. These shortcomings and uncertainties should be addressed, in consultation with industry, as part of the Government's ongoing review of the MIT tax framework.

These reforms are also important to our future capacity to attract foreign investment into our economy. In view of this, AVCAL recommends that the Government:

- Release the Board of Taxation's review of CIVs, together with its response to the report;
- Provide legislative certainty for the retention of character and source for investors in MITs, and address other areas of the MIT tax framework to allow these vehicles to operate in as similar a fashion as possible to how international CIVs are taxed in other jurisdictions; and
- Prioritise, as part of the proposed Tax White Paper in the next two years, the implementation of policies that will support Australia's capacity to attract capital from domestic and international investors through a globally competitive environment for collective investment management activities.

[25] Senate Notice Paper No.143 – 14/5/2013; Orders of the Senate, Senator Mathias Cormann