International Tax Base Unit
Corporate and International Tax Division
The Treasury
Langton Crescent,
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Attention to:
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12 September 2013

Dear Sir or Madam

Submission on Element 3 Exposure Draft Two – Tax Laws Amendment (2013 Miscellaneous Measures No.1) Bill 2013: Investment Manager Regime ("IMR")

The Managed Funds Association ("MFA"),[1] together with the Alternative Investment Management Association ("AIMA"),[2] together referred to as the "Associations," appreciate the opportunity to provide further feedback to the Australian Treasury (the "Treasury") with respect to the second Exposure Draft released on 31 July 2013 (the "Second Exposure Draft") in relation to the third element of IMR ("IMR 3").

Members of the Associations have been closely following the development of the IMR and the Associations would like to refer to their submissions to the Treasury on 5 December 2012 (the "December Letter")[3] in respect of the previous elements of the Regime ("IMR 1 and 2") and their previous submission on 26 April 2013 (the "April Letter")[4] in relation to the Exposure Draft to the IMR 3 released on 4 April 2013 (the "First Exposure Draft"). We appreciate the Treasury's willingness to consider concerns which we and others have raised to date.

We would like to reiterate that we strongly support the objectives of the IMR 3 proposals set out in the Explanatory Memorandum, especially those to:[5]

- *"provide certainty in relation to the Australian income tax treatment of income from certain financial arrangements of qualifying widely held foreign funds;*

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[1] The Managed Funds Association (MFA) represents the global alternative investment industry and its investors by advocating for sound industry practices and public policies that foster efficient, transparent, and fair capital markets. MFA, based in Washington, DC, is an advocacy, education, and communications organization established to enable hedge fund and managed futures firms in the alternative investment industry to participate in public policy discourse, share best practices and learn from peers, and communicate the industry's contributions to the global economy. MFA members help pension plans, university endowments, charitable organizations, qualified individuals and other institutional investors to diversify their investments, manage risk, and generate attractive returns. MFA has cultivated a global membership and actively engages with regulators and policy makers in Asia, Europe, the Americas, Australia and other regions where MFA members are market participants.

[2] AIMA is the trade body for the hedge fund industry globally; our membership represents all constituencies within the sector – including hedge fund managers, fund of hedge funds managers, prime brokers, fund administrators, accountants and lawyers. Our membership comprises over 1,300 corporate bodies in over 50 countries.

[3] The December Letter is available at: https://www.managedfunds.org/wp-content/uploads/2013/01/Australia-IMR-AIMA-MFA-joint-submission-5-Dec-12.pdf.

[4] The April Letter is available at: available at: https://www.managedfunds.org/wp-content/uploads/2013/04/MFA-AIMA-joint-letter-on-IMR-3.pdf.

[5] Explanatory Memorandum to Tax Laws Amendment (2013 Miscellaneous Measure's No.1) Bill 2013: Investment Manager Regime.

- *expand the exemption for qualifying investment income of certain foreign widely held managed funds; and*
- *reduce compliance costs by removing the need for investors to work through sophisticated provisions of the law."*

We were also encouraged by the Government's Media Release on 16 December 2011, in which the Minister for Financial Services and Superannuation (at that time), Bill Shorten, announced that:

> "*The IMR will provide certainty of tax treatment for the funds management sector … and will further enhance Australia as a financial services centre in the Asia Pacific region*. Further Mr Shorten stated *"The implementation of the IMR …ensures that Australia's taxing arrangements with regards to passive portfolio investments are in line with international norms and will make Australia a more attractive place to do business for foreign funds."*[6]

While we support the objectives of the IMR proposals, we are concerned that, as drafted, a very significant number of hedge funds managed by our members will not qualify as IMR foreign funds for purposes of IMR 3. This will create significant tax uncertainties for those funds, making it less attractive for those funds to invest in Australia. We believe this is not the result intended by the Treasury and we welcome further dialogue with the Treasury on how the IMR could be amended to achieve our shared objectives. In that regard, we note that there are regimes with similar objectives in other jurisdictions that may provide a useful reference point for the Government in creating a new IMR.

The Associations have previously commented on specific concerns in the First Exposure Draft,[7] many of which we believe continue to be of concern in the Second Exposure Draft. We also have concerns with respect to certain of the new provisions included in the Second Exposure Draft. As an initial matter, however, we believe it would be useful to provide a discussion of the typical structures and arrangements used by many hedge funds to demonstrate why the current draft of the IMR is likely to exclude many of them from the definition of "IMR foreign fund" in the legislation.

We have included in an Annex to this letter summary information on the hedge fund industry, including typical hedge fund structures, and the difficulties which the Second Exposure Draft presents for them.

We would be very happy to discuss with the Treasury our comments with respect to the key issues outlined in this letter or any of the other issues regarding the tax treatment of foreign investment funds under the IMR 3. If the Treasury has any comments or questions, please do not hesitate to contact either Benjamin Allensworth (ballensworth@managedfunds.org) or Stuart Kaswell (skaswell@managedfunds.org) at +1 (202) 730-2600 or Mary Richardson (mrichardson@aima.org) at +44 (0) 207 822 8380.

Respectfully submitted,

/s/ Stuart J. Kaswell

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[6] Media Release No.168: Government Announces Final Element of Investment Manager Regime

[7] *See* the April Letter.

ANNEX

Overview of Hedge Fund Industry

Hedge funds are pooled investment funds sold to sophisticated investors, including institutional investors (such as pension plans and endowment funds) and high net worth individuals. Institutional investors include funds of hedge funds, which are themselves pooled investment funds that invest in a number of underlying hedge funds. Hedge fund interests typically are not traded on exchanges, but instead are sold in direct offerings to sophisticated investors. Hedge fund interests may be sold directly to investors by the fund or through distribution arrangements with financial institutions, such as banks or brokerage firms.

Hedge Fund Structures

Hedge funds may be structured as partnerships or corporate entities. As such, for the IMR to be available to hedge funds generally, both partnership and corporate structures would need to be included with the scope of foreign funds. Hedge funds often are established into a master-feeder arrangement or a side-by-side arrangement.[8]

Side-by-Side Funds

In a side-by-side arrangement, investors that are similarly situated (*e.g.*, all US taxable persons) invest in one fund, while other similarly situated investors (*e.g.*, US tax-exempt investors or non-US investors) would invest in a separate fund, typically one that is located in a tax neutral jurisdiction, such as the Cayman Islands. Each of the side-by-side funds typically invests according to substantially similar investment strategies and invests in substantially similar assets. Along with outside investors, the manager of the fund often invests its own assets (either directly or through an affiliated entity that is typically a partnership or similar entity) in the fund.

Master-Feeder Funds

In a master-feeder structure, investors that are similarly situated invest in a so-called feeder fund. Each of the feeder funds invests substantially all of its assets into a master fund, which is the entity that engages in the investing and trading activity. Profits and losses of the master fund are allocated *pro rata* among the feeder funds. A master fund may have two or more feeder funds, depending on the nature of the underlying investors, and also may have some direct investors. As in side-by-side arrangements, the manager typically invests in the fund as well as outside investors. In the master-feeder arrangement, there may be as few as two direct investors in the master fund, though these direct investors (typically the feeder funds) will have many underlying investors.

With respect to both side-by-side arrangements and master-feeder arrangements, hedge funds typically have a number of outside investors, more than the 25 contemplated by the Second Exposure Draft. We believe that it is important for the final IMR legislation to ensure that any "widely held test" appropriately considers the different methods by which outside investors may invest in a hedge fund.

Managed Accounts

Some hedge fund managers also utilize managed accounts, often at the request of investors that want greater control over their investments. A managed account is an investment structure that is set up and governed by the managed account provider/client or similar entity to manage the assets pari-passu with the reference hedge fund. These types of managed accounts are sometimes referred to as "parallel accounts" because the managed account's assets are invested in parallel with the assets of the hedge fund.

Typically, the managed account will be set up as a separate vehicle, enabling the ring-fencing of the assets. Managed accounts are becoming increasingly popular as investors want to see their investment managed carefully and in a fully controlled environment. If managed accounts are not accommodated in the IMR, that would certainly discourage managers from locating in Australia since they would be restricted from a large part of their potential client/asset base. As such,

[8] There are a number of other common hedge fund structures, many of which are discussed in the December Letter.

Australia's financial services industry would "miss out" on a significant pool of foreign investment if managed accounts are not permitted in terms of the IMR.

Managed account platforms will not be able to satisfy the widely held test and closely held test as one investor generally owns a 100% interest in a managed account. For fund managers that operate managed accounts, there may be additional issues created where the fund itself is within the IMR. If the managed account is set up to follow the same investment strategy as the fund, it may be unable to achieve this if it is unable to fit within the scope of the IMR. This may force the fund that is within the IMR to avoid investing directly into Australia, so that it does not create tracking errors with the managed account.

Ownership by Management

It also is important for any final IMR legislation to ensure that any "closely held test" permits ownership by the hedge fund manager and its affiliates. In particular, it is important to note that, in addition to any initial investment by the manager and its affiliates, the compensation structure of the hedge fund industry tends to increase the manager's fund ownership over time. Hedge fund managers typically earn a management fee, based on the net asset value of the fund, as well as a performance fee or performance allocation, which is a percentage of the profits earned by the fund. With respect to funds that are structured as limited partnerships (which most U.S. domiciled funds and some non-U.S. domiciled funds are) managers often will keep their performance allocation invested in the fund, which helps to align manager and investor interests. While the percentage amount of performance allocations varies across the industry, a performance fee of 20% or greater is quite common. In light of the ownership and compensation arrangements typical in the industry, we believe that the thresholds for the "closely held test" set out in the Second Exposure Draft are likely to exclude many hedge funds.

Intermediary Investors

Funds-of-funds and financial institution investors do not provide the identities of their underlying investors or clients to the fund in which they invest.

There are a variety of arrangements by which a financial institution acts as a nominee investor; however, regardless of the arrangement, the financial institution typically does not share the identity of its underlying clients for business reasons. (For competitive reasons, a bank that engages in discretionary money management for its clients would not want to provide its client lists to another investment management firm). The financial institution does provide various representations regarding the nature of their clients so that the hedge fund can meet regulatory obligations, such as "know-your-customer" rules.

We appreciate that the Second Exposure Draft attempts to address concerns about a look-through requirement for purposes of IMR 3; however, we remain concerned that the look-through rules would be problematic for many hedge funds that have third parties as intermediary investors. For the reasons discussed above, it is impracticable for these funds to look-through to the underlying investors to determine whether the fund would meet the requirements of the closely held test.

Start-Up and Wind-Down Phases

Further, regardless of the structure of the fund, it is important that the IMR take into consideration the timeframes typically needed to start-up or wind-down a hedge fund. The majority of hedge fund investors are institutions that undertake a significant and time consuming diligence process prior to making an investment in a hedge fund. As part of this process, institutional investors may require a fund to establish a performance record for a period of time before those investors will commit capital. That diligence process may take anywhere from 6 to 18 months, or potentially longer, depending on the length of the track record an investor requires. We believe the IMR legislation should include a reasonable period of time for start-up funds to meet the thresholds.

Similarly, a fund winding down its investment portfolio may need time to sell of illiquid positions or to avoid selling off liquid positions at a disadvantageous time. This flexibility allows investment managers to meet their fiduciary obligations to investors and avoid fire sales, which can adversely affect investors. We believe the IMR should provide funds with a reasonable period of time to wind down their portfolios in a manner that is consistent with the investors' best interests.