



ASIC

Australian Securities & Investments Commission

CONSULTATION PAPER 82

Wholesale equity venture capital schemes: trustee licensing

May 2007

What this paper is about

1. This consultation paper sets out our proposals for class order relief for trustees of certain wholesale equity schemes from the requirement to hold an Australian financial services (AFS) licence to provide for the members of the scheme a custodial or depository service and to deal in financial products they hold on trust. We expect our proposals to be particularly relevant to venture capital schemes. The Appendix provides more background on the application of the AFS licence regime under the *Corporations Act 2001* to wholesale equity schemes.
2. The relief we are consulting about relates to schemes that have a manager who accepts responsibility for the trustee's compliance and is an AFS licensee who is a related body corporate of the trustee.
3. We have given interim class order relief for trustees of wholesale equity schemes until 31 December 2008 for these financial services.
4. This paper seeks your comments on whether we should extend relief and, if so, on what terms.

Making a submission

5. You are invited to comment on our proposals, which are only an indication of an approach we may take and are not our final policy.
6. As well as responding to the specific proposals and questions, please describe any alternative approaches you think would achieve our objectives. We would also like to hear from you on any related issues you consider important.
7. As we are particularly keen to fully understand and assess the competitive, financial and other impacts of our proposals and any alternative approaches, we ask you to comment on:
 - (a) the likely effect on competition;
 - (b) the likely compliance costs; and
 - (c) other impacts, costs and benefits.
8. Where possible, we are seeking both quantitative and qualitative information. Your comments will help us develop our policy on licensing of trustees of wholesale equity schemes. In particular, any information about compliance costs, impacts on competition and other impacts, costs and benefits will be taken into account if we prepare a Business Cost Calculator report and/or a Regulation Impact Statement: see Section 3.
9. All submissions will be treated as public documents unless you specifically request that we treat the whole or part of your submission as confidential.
10. After the consultation period, we aim to publish our final policy by June 2008.

Your comments

Comments are due by 15 August 2007 and should be sent to:

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You can also contact ASIC Infoline on 1300 300 630 for information and assistance.

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Section 1: Which wholesale equity schemes are we considering?

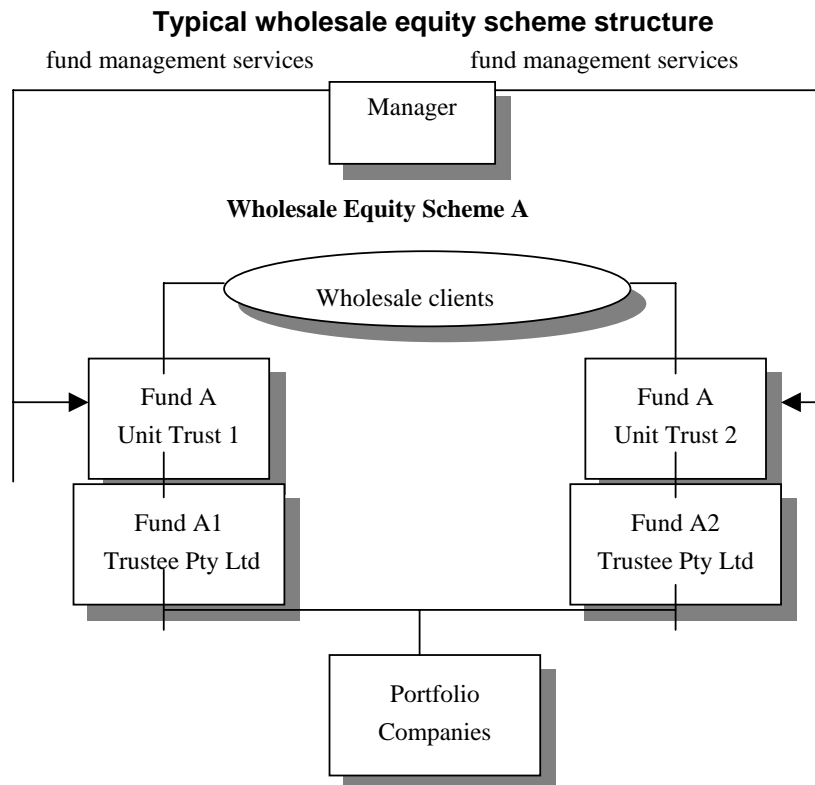
11. In this consultation paper we are considering managed investment schemes:

- (a) that primarily invest in unlisted companies; and
- (b) have only wholesale clients as members.

12. A managed investment scheme will not need to be registered under Chapter 5C of the *Corporations Act 2001* if all the issues of interests in the scheme would not have required the giving of a Product Disclosure Statement (PDS). This will be the case for wholesale equity schemes that are marketed only to wholesale clients.

13. Many wholesale equity schemes are made up of a number of different arrangements, typically unit trusts and sometimes, especially if there are overseas investors, limited liability partnerships. Often the structure of a scheme will involve multiple unit trusts having separate corporate trustees. Wholesale equity schemes may be established using a multiple trusts structure to ensure that the trusts are not treated as public trading trusts for tax purposes.

14. Although wholesale equity schemes often consist of a number of separate trustees, generally fund management services will be carried out by a single fund manager who is an AFS licensee. Typically, the trustees are related bodies corporate of the fund manager. The following diagram illustrates a typical structure:



Section 2: Licensing relief for trustees

Interim relief

15. We have given interim licensing relief under Class Order [CO 07/74] for trustees of wholesale equity schemes.

16. When a wholesale equity scheme is essentially operated by the manager, we consider that the requirement for the trustee to hold or the trustees to each hold an AFS licence carrying the appropriate authorisations may impose a disproportionate cost burden. The conditions of [CO 07/74] are intended to ensure that:

- our relief will not affect services provided to retail clients; and
- the manager, as an AFS licensee, accepts responsibility to clients for financial services provided by the trustee as if the trustee were its representative.

17. The interim relief allows trustees of wholesale equity schemes to deal in, and provide custodial or depository services (together 'wholesale equity financial services') for certain investment products held by the wholesale equity scheme, without holding an AFS licence.

18. The interim class order only extends to certain types of wholesale equity schemes, namely unregistered managed investment schemes with the following characteristics:

- (a) scheme assets consist only of investment products, other than incidental holdings of cash or certain highly liquid assets; and
- (b) at all times the value of the investment products which are quoted on a financial market is less than 20% of the total value of scheme assets. The 20% limit allows for cases when, for example, a company in which an investment was made subsequently lists on a financial market and the shares in that company are retained by the wholesale equity scheme. The value of scheme assets is to be determined according to the trustee's reasonable estimate of the market value of those assets.

19. The investment products held by the wholesale equity scheme must be limited to:

- (a) securities within the meaning given by s761A;
- (b) options to acquire by way of transfer a security covered by paragraphs (a), (b) or (c) of the definition of 'security' in s761A; or
- (c) interests in a managed investment scheme; or
- (d) options to acquire an interest in a managed investment scheme.

Your feedback

- Q1** Do you agree with giving ongoing relief? If so, why, and if not, why not? Would giving relief risk market integrity? If so, why?
- Q2** Are there any other financial services for which licensing relief is appropriate for trustees of wholesale equity schemes? If so, what are they?
- Q3** Are the 'investment products' sufficiently broad enough to cover the range of wholesale equity investments that should be addressed by the relief? If not, what other products should be included?
- Q4** Is the 20% limit on investments in quoted products an appropriate limit? Should the relief be limited to wholesale equity schemes that invest only in unquoted products or instead allow any investment acquired before it was quoted or there was a proposal to quote it?
- Q5** In calculating the value of scheme assets for the purposes of the 20% limit, is it appropriate to base the calculation on the trustee's reasonable estimate of market value of the assets or should the valuation be determined according to the AASB accounting standards?

20. The interim licensing relief for the provision of these wholesale equity financial services only applies when:

- (a) the trustee and manager take reasonable steps to ensure that interests in the wholesale equity scheme are acquired by wholesale clients only; and
- (b) a related body corporate ('manager') of the trustee holds an AFS licence that authorises the manager to provide the wholesale equity financial services and that licence contains special licence conditions.

Special licence conditions for manager

21. The manager's AFS licence must contain conditions that the manager must:

- (c) as far as possible, comply with the Act as if the trustee were providing the wholesale equity financial services as the manager's representative; and
- (d) have in place a deed poll for the benefit of scheme investors. The effect of this must be that the manager will indemnify the scheme investors for any liability (except a liability for which the trustee may be indemnified from the trust property of the wholesale equity scheme) that arises from the trustee's provision of the wholesale equity financial services to investors; and

- (e) for the purposes of the relevant financial conditions of the manager's licence - treat the assets, liabilities and cash flows of the trustee as though they were the assets, liabilities and cash flows of the manager.

Manager's 'incidental' custodial role

22. AFS licences contain a standard condition that the licensee must have at least \$5 million net tangible assets (NTA) when the licensee has custody of client assets other than incidentally to another financial service being provided by the licensee or a related body corporate: Policy Statement 166 *Licensing: Financial Requirements* [PS 166] at [PS 166.63].

23. We consider that the trustee of a wholesale equity scheme will usually have custody of assets incidentally to financial services being provided by its related body corporate, the manager of the scheme. Similarly if one were to take the manager as holding the assets themselves, the holding would be incidental to financial services provided by the manager. We expect that the principal purpose of the financial services provided by the manager of a wholesale equity scheme will be to arrange for the investment of funds in financial products on behalf of investors. Accordingly, the custody of assets acquired through the investment of investor's funds will be incidental to that purpose. This position is consistent with [PS 166] which contemplates that the custodial services provided by operators of wholesale investment trusts will be incidental to their principal purpose: [PS 166.75].

24. Therefore, we expect that the manager will generally not need to satisfy the \$5 million NTA requirement because it will have custody of client assets incidentally to another financial service being provided by itself or a related body corporate.

25. The manager will usually need to have \$50,000 in surplus liquid funds (SLF) because, as a result of the proposed licence conditions, it is taken to be holding the assets the trustee holds on trust, which are assets held on trust for clients: see Section E of [PS 166]. This SLF requirement:

- (a) reduces the risk that insolvency will tempt the manager to misuse client assets; and
- (b) helps to ensure the manager will be able to give the trustee access to sufficient financial resources to enable legal title to the investment products to be transferred if the trustee is removed from office.

26. The manager will not usually need to satisfy our adjusted surplus liquid funds requirement in Section F of [PS 166] because it is unlikely that the trustee will be incurring liabilities by entering into a transaction with a client in the course of providing a financial service to the client.

Trustee's financial requirements

27. The trustee or manager should also ensure the trustee complies with the base level financial requirements in Section B of [PS 166] if the trustee were required to hold an AFS licence. Where the trustee or manager becomes aware that the trustee would have breached the base level financial requirements, the trustee or manager must notify ASIC within 10 business days of becoming so aware. On receiving notice, ASIC will decide whether the trustee can continue to rely on the relief.

Your feedback

- Q6** Does the requirement for a deed poll, under which the manager will indemnify scheme investors for any liability arising from the trustee's provision of the wholesale equity financial services, present any practical difficulties for the manager? If so, what are they and what alternative means would ensure that there is incentive for a manager to ensure compliance?
- Q7** Is there a basis for an additional requirement for the manager to have \$100,000 or some higher amount in surplus liquid funds to better cover any costs that may arise if the assets are to be transferred by a trustee?
- Q8** Is it disproportionately burdensome to require the trustee to comply with the base level financial requirements (including obtaining an audit opinion) as if it held an AFS licence in circumstances where the manager is subject to the same requirements under its AFS licence and must treat the assets, liabilities and cash flows of the trustee as if they were those of the manager?

Relief expires in December 2008

28. The interim class order expires on 31 December 2008. We have given interim relief to enable us to:

- (a) further consider the appropriateness of the AFS licensing requirements to trustees of wholesale equity schemes; and
- (b) discuss the form and content of any ongoing relief with industry.

Our proposals for ongoing licensing relief

29. We propose to give ongoing relief for the financial services that the trustee of a wholesale equity scheme will generally provide. We propose to give this relief on the same terms as our interim class order relief.

Section 3: What happens next?

Regulatory and financial impact

30. We have carefully considered the regulatory and financial impact of the policy proposals in this paper. Based on the information that we currently have, we believe that our proposals strike an appropriate balance between facilitating financial services relating to wholesale equity schemes and the risks to clients and the integrity of the markets for those products and associated financial services.

31. Before settling on our final policy, we will comply with the requirements of the Office of Best Practice Regulation (OBPR) by:

- (a) considering all feasible options;
- (b) undertaking a preliminary assessment of the impacts of the options on business and individuals or the economy if regulatory options are under consideration;
- (c) consulting with OBPR to determine the appropriate level of regulatory analysis if our proposed option has more than low impact on business and individuals or the economy; and
- (d) conducting the appropriate level of regulatory analysis, that is, completing a Business Cost Calculator report (BCC report) and/or a Regulation Impact Statement (RIS).

32. All BCC reports and RISs are submitted to the OBPR for approval before we make any final decision. Without an approved BCC Report and/or RIS, ASIC is unable to give relief or make any other form of regulation, including issuing a regulatory guide that contains regulation.

33. To ensure that we are in a position to properly complete any required BCC report or RIS, we ask you to provide us with as much information as you can for our proposals or any alternative approaches about:

- (a) the likely compliance costs;
- (b) the likely effect on competition; and
- (c) other impacts, costs and benefits.

Note: See 'Making a submission' at the beginning of this paper.

Development of final policy

34. This paper is not ASIC policy. Any application for relief outside existing interim relief will continue to be considered under the current framework in Policy Statement 167 *Licensing: Discretionary powers* [PS 167].

35. We expect to publish policy in June 2008, after considering any comments or feedback you send us on these proposals.

Your feedback

Q9 Do you have any information about the cost and benefits of our proposals or any alternative options? If so, please provide details.

Key terms

In this consultation paper these terms have the following meanings:

Act means the *Corporations Act 2001* including regulations made for the purposes of the Act.

AFS licence means an Australian financial services licence.

ASIC means Australian Securities and Investments Commission.

[CO 07/74] means (for example) an ASIC Class Order (in this example numbered 07/74)

custodial or depository service has the meaning given by s766E.

dealing has the meaning given by s766C.

[PS 166] means (for example) an ASIC policy statement (in this example numbered 166).

relevant financial conditions, in relation to an AFS licence, means conditions to the effect of conditions 13 (base level requirements), 21 (financial requirements for holding client money or property) and 22 (financial requirements for licensee transacting with clients) of ASIC Pro Forma 209 *Australian financial services licence conditions*.

s766E means (for example) a section of the Act (in this example numbered 766E).

wholesale client has the meaning given by s761G.

Appendix: AFS licensing regime

1. Under the Act, it is likely that many trustees of wholesale equity schemes may require an AFS licence. This section briefly explains how (without relief) we consider the AFS licensing regime applies to these trustees.
2. A person who carries on a financial services business in Australia must hold an AFS licence covering the provision of the financial services, unless an exemption applies.
3. A trustee of a wholesale equity scheme may require an AFS licence because it will be:
 - (a) providing a custodial or depository service if it holds financial products (for example, shares in unlisted companies) in trust for, or on behalf of, the members of the scheme: s766E;
 - (b) dealing, when acquiring and disposing of financial products (for example, shares in unlisted companies) on behalf of members of the scheme: s766C(1)(a) and (e); and
 - (c) dealing, if it is issuing interests in the wholesale equity scheme: s766C(1)(b). An interest in an unregistered managed investment scheme may be a financial product: s764A(1)(ba). The trustee may be issuing interests in the wholesale equity scheme if it is responsible for obligations owed, under the terms of the facility that is the product, to members: s761E(4).
4. There are certain exemptions that may apply depending on the circumstances. For example:
 - (a) when the trustee and its associates provide custodial or depository services to no more than 20 clients in total, the trustee will not be regarded as providing a custodial or depository service: reg 7.1.40(c). Acquisitions and disposals as trustee in such circumstances are also not treated as dealing: reg 7.1.35(1)(b); and
 - (b) if the wholesale equity scheme is not registered, has no more than 20 members and is not promoted by a professional promoter, then an interest in the wholesale equity scheme may not be a financial product and so issuing interests in the scheme will not be providing a financial service: s765A(1)(s); and
 - (c) when a trustee is issuing interests in the wholesale equity scheme, it could issue the interests under an arrangement ('intermediary authorisation') between itself and the manager (an AFS licensee), without holding an AFS licence: s911A(2)(b).
5. Although these exemptions may apply in particular circumstances, they will generally not apply for all the financial services

that trustees provide and therefore, in the absence of relief, the trustee of a wholesale equity scheme is likely to require an AFS licence.

6. Chapter 7 of the Act accommodates a limited form of ‘group licensing’ to the extent that it allows for bodies corporate (including related bodies corporate) to be authorised representatives of AFS licensees. However, reliance on a single AFS licence is not possible when the other unlicensed companies are not acting as representative because they are not acting on behalf of the licensee (ie they are acting as principal). On when a financial service provider is acting as principal see *Licensing: The scope of the licensing regime: Financial product advice and dealing* (Guide) which sets out some general indicators. The wholesale equity financial services provided by the trustee are unlikely to be considered to be from the trustee as representative. This is because the trustee will undertake and be personally responsible for obligations to clients under the terms of the trusts and this is reflected in that the trustee holds financial products (for example, shares in unlisted companies) in its own name on behalf of clients, and has ownership of, access to, or liability for, client information: para 3.3.3 of the Guide.

7. ASIC Policy Statement 167 *Licensing: Discretionary powers and transition* [PS 167] explains how we will exercise our discretionary powers on licensing. We have the power under s911A(2)(1) to give relief from the licensing requirement. Relief may be conditional.

8. As a general rule, we will not give licensing relief solely on the basis that the financial services will be provided to wholesale clients only. This would be contrary to Parliament’s intention to apply the AFS licensing regime across both retail and wholesale sectors. We will take into account the factors set out in [PS 167.3C]. Even in the absence of the need to protect retail clients, ASIC must still consider whether, when the proposed requirements for relief are satisfied, there would be any substantial reduction in the protection of market integrity that the AFS licensing regime was enacted to produce.