

Investment funds - registered versus unregistered managed investment schemes in Australia

By Nick Humphrey Partner Sparke Hellmore Lawyers – Thank you Nick.

Typically, investment funds in Australia are structured as unit trusts, which is the most common form of syndicated investment vehicle in this jurisdiction.

By way of comparison, investment vehicles in other jurisdictions (e.g. the United States, United Kingdom, New Zealand, Hong Kong, Singapore, Cayman Islands, Bermuda and Jersey) are often structured as limited partnerships. In Australia, the *Venture Capital Act 2002* (Cth) provides for a structure known as the "venture capital limited partnership", however this has limited application. Investment funds in Australia are generally what are referred to as "managed investment schemes", which is a specifically defined term under the *Corporations Act 2001* (Cth). Managed investment schemes are subject to certain regulatory requirements, including the Australian Financial Services Licence (AFSL) regime under the Corporations Act. The definition of "managed investment scheme" deliberately excludes certain bodies, including body corporates, insurance statutory funds, superannuation funds, retirement village schemes and partnerships.

The purpose of this article is to outline when an investment fund structured as a unit trust should be a registered managed investment scheme compared with when it should be an unregistered managed investment scheme, and to highlight the key differences between registered and unregistered schemes.

Private trust v managed investment scheme

A private unit trust is differentiated from a managed investment scheme because in a private trust structure, the beneficiaries of the trust (i.e. the unitholders) have control of the day-to-day operations of the trust. An example of a private trust is where four colleagues establish a unit trust to be the vehicle used to acquire a property, and they are the sole beneficiaries of the trust and shareholders and directors of the trustee, and they control and manage the day-to-day affairs of the trust.

When does a unit trust become a managed investment scheme?

A unit trust will be a managed investment scheme under the Corporations Act where the investors in the trust, who have pooled their funds for a common purpose, *do not have* day-to-day control of the trust. A unit trust with passive investors will therefore be a managed investment scheme.

When must a managed investment scheme be registered under Chapter 5C of the Corporations Act?

A managed investment scheme must be registered as a managed investment scheme under Chapter 5C of the Corporations Act where the units in the trust/scheme are to be offered to retail

clients¹ beyond the \$2 million / 20 investor / 12 month limit (Small Scale Offer Exemption) in section 1012E of the Corporations Act.²

As a general rule, where it is intended that interests in a trust or scheme will be promoted to retail investors and the Small Scale Offer Exemption is not being relied on, then such scheme is required to be registered with the Australian Securities and Investments Commission (ASIC) under Chapter 5C of the Corporations Act.

The registration of a scheme requires, among other things, that the scheme's constitution meet specific requirements in Chapter 5C of the Corporations Act, the scheme have a compliance plan and the scheme must have a board and/or compliance committee that meets the "external" member requirements set out in Chapter 5C of the Corporations Act.

What are the implications of failing to register a scheme which should be registered?

If a person operates an unregistered managed investment scheme that is otherwise required by the Corporations Act to be registered, then there are a number of adverse consequences that may apply, including:

- a maximum penalty for individuals of 200 penalty units (\$22,000) or five years imprisonment, or both or a maximum penalty for corporations of 1,000 penalty units (\$110,000)
- upon application by ASIC, the person operating the scheme or a member of scheme to the court, the unregistered scheme may be wound up by the Court (s 601EE of the Corporations Act)
- where a court finds that an investor has suffered, or is likely to suffer loss or damage because of the contravention, the Court may make orders to compensate that investor for their loss or damage (s 1325 of the Corporations Act), and
- a contract entered into by an investor to subscribe for the interests is voidable at the option of the investor (s 601MB of the Corporations Act).

Registered v unregistered schemes

A managed investment scheme that is only promoted to wholesale investors is not required to be registered. Some fund managers, however, register funds that are only promoted to wholesale investors to commit (and demonstrate a commitment) to a corporate governance and compliance regime which provides regulatory safeguards for investors.³

The following table highlights some of the key issues and differences between unregistered managed investment schemes (or wholesale trusts) and registered managed investment schemes (or retail trusts). It is important to know when registration is required and what is involved.

Question	Unregistered scheme (wholesale trust)	Registered scheme (retail trust)
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Who are my target investors?

An unregistered scheme should only be promoted to wholesale investors, however, the trustee may also raise up to \$2 million from up to 20 retail investors in a 12 month period by way of personal offers.

The legislative reason for registering a scheme with ASIC is because the scheme will be promoted to retail investors and the Small Scale Offer Exemption is not being relied on.

A registered scheme may also be promoted to wholesale investors.

Who is the trustee entity and what is the usual fund structure?

The trustee is usually a proprietary limited company (which may have a sole director).

The trustee is referred to as a "responsible entity", which must be established as a public company and have at least three directors. A responsible entity is a defined term in the Corporations Act and is subject to certain regulatory requirements (including the requirement to have a specific type of AFSL authorisation under the AFSL regime).

There may also be a manager (also a proprietary limited company) which provides investment and fund management services to the trustee for a fee (or fees).

It is common for there to also be a manager (usually a proprietary limited company) which provides investment and fund management services for a fee (or fees).

As trustee or responsible entity, do I need an AFSL?

Although there are some limited exemptions for some authorisations and arrangements may be made with AFSL holders (to perform financial services on behalf of the trustee), generally a trustee of a wholesale trust will require an AFSL, which includes authorisations to:

- issue the units in the trust (i.e. deal in own scheme interests)
- provide advice in relation to the units in the trust (e.g. issuing an information memorandum and other promotional material)
- deal in any financial products held by the trustee as trust assets (if any) (it is

A responsible entity of a registered scheme will require an AFSL, which includes authorisations to:

- operate a registered scheme
- issue the interests in the scheme (i.e. deal in own scheme interests)
- provide advice in relation to units in the scheme (e.g. issuing promotional material to prospective investors), and
- deal in any financial products held by the responsible entity as scheme assets (if any) (it is important to note that property is not a financial product, but insurance and an interest rate hedging

important to note that property is not a financial product, but insurance and interest rate hedging products are), and

- provide a custodial service.

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The AFSL regime for registered schemes also imposes additional licence conditions and other requirements, including requirements to: be a member of an external dispute resolution scheme, have in place a certain level of financial resources and meet strict NTA requirements (see below), have adequate compliance and risk management arrangements in place, and have in place appropriate professional indemnity insurance arrangements.

Wholesale trusts or unregistered schemes that are exempt from the requirement to hold an AFSL are not subject to specific regulation under the Corporations Act.

However, if the promoter/trustee is subject to the AFSL regime, then the trust/scheme must comply with the related requirements under the Corporations Act. There are also a number of ASIC Regulatory Guides and ASIC Class Orders applicable to financial services licensees.

Promoters of wholesale trusts or unregistered schemes (whether holding an AFSL or not) are subject to the prohibitions applicable to all persons involved in financial services not to engage in misleading or deceptive conduct.

What regulatory requirements must I meet?

Registered schemes are subject to the specific requirements imposed by Chapter 5C and Chapter 7 of the Corporations Act, including those relating to: scheme constitution provisions regarding unit issue and redemption prices, withdrawal rights, winding up, deregistration, and replacement of the responsible entity; and disclosure obligations relating to the issue of a product disclosure statement (PDS). There are also numerous ASIC Regulatory Guides and ASIC Class Orders applicable to the operation, governance, fund raising activities and disclosure obligations of registered schemes.

A registered scheme can only be established with the approval of ASIC. The responsible entity must have already obtained the relevant AFSL authorisation to operate a registered scheme and then may make an application to ASIC for registration of the scheme (and ASIC must register or reject a scheme within 14 days of lodgement of an application with ASIC). The application

What do I need to do to establish my trust or scheme?

A wholesale trust or unregistered scheme can be established by the trustee entering into a trust deed or constitution (which sets out the terms of the contractual and trust relationship between the trustee and investors in the trust).

must include:

- (a) a copy of the scheme's constitution
- (b) a copy of the scheme's compliance plan, and
- (c) a statement signed by the directors of the proposed responsible entity that (a) and (b) comply with the requirements of the Corporations Act.

Consent from a person who has consented to be the auditor of the compliance plan must also be given.

In addition to meeting the base level financial requirements, a responsible entity must meet the NTA requirements set out in ASIC Regulatory Guide 166 (currently this requires a responsible entity to have NTA of 0.5% of the gross assets of the registered funds under management, with a minimum of \$50,000 and a maximum of \$5 million).

Financial requirements for responsible entities will change from November 2012.4

The responsible entity of a registered scheme must establish a compliance committee if less than half the directors of the responsible entity are external directors (s 601JA of the Corporations Act). The organisational competency requirements for licensees set by ASIC also apply.

A financial report and a directors' report must be prepared for each financial year (s 292(1)(d) of the Corporations Act)

The compliance plan for the scheme must be audited annually by an external auditor.

The responsible entity must lodge the auditor's report (in respect of the

A trustee of a wholesale trust or unregistered scheme that holds an AFSL must meet what are referred to as the "base level financial requirements", including solvency, cash needs and audit requirements. Generally, trustees are required to prepare rolling three month cash flow forecasts that show that the trustee can meet its ongoing financial obligations.

What financial requirements do I need to meet?

There are no prescribed board requirements. However, if the trustee is required to hold an AFSL, then the trustee must satisfy the organisational competency requirements for licensees set by ASIC.

Does my board of directors need to meet any specific criteria?

There are no prescribed requirements, unless the trustee is required to hold an AFSL.

If the trustee has an AFSL, reporting requirements include the lodgement of audited financial statements with ASIC (s 989B of the Corporations Act), notification requirements in relation to responsible managers, the provision of information to

What are my reporting obligations?

ASIC as directed or as required by the regulations (ss 912C and 912CA of the Corporations Act) and breach reporting requirements (s 912D of the Corporations Act).

compliance plan), together with the financial report and directors' report with ASIC (s 601HG(7) of the Corporations Act).

Periodic statements must be provided to investors and continuous disclosure obligations may also apply (ss 675 and 1017D of the Corporations Act).

Generally, a trustee or operator of an unregistered scheme is required to hold an AFSL authorising it to provide a custodial service unless a third party custodian is used.

The responsible entity is able to perform the role of custodian (and hold the scheme's assets) without a specific AFSL authorisation, however, it must meet the threshold financial resources required by ASIC, i.e. at least \$5 million NTA.

Do I need to have an external custodian? It is common for a licensed external custodian to be appointed.

Licensed external custodians are commonly appointed, which meets those financial requirements.

What type of offer document can I give to potential investors?

An information memorandum or fund profile document is generally used to promote the fund to wholesale investors.

A product disclosure statement (PDS) is generally required for offers of interests in a registered scheme to retail clients (Part 7.9 of the Corporations Act).

What do I need to know about stamp duty and tax?

It is imperative that stamp duty and tax advice is sought prior to establishing an unregistered scheme or wholesale trust.

It is imperative that stamp duty and tax advice is sought prior to establishing a registered scheme.

This article discusses at a high level some of the key considerations for establishing a unit trust or managed investment scheme in Australia and the related requirements for determining whether a scheme should be registered or unregistered. Depending on your individual circumstances there may be other considerations and regulatory requirements that may be applicable.

This article is current as at May 2012. It is provided for information purposes only and should not be relied upon in the absence of specific legal advice relevant to your particular circumstances.

Further information

The funds and financial services team at Sparke Helmore have extensive experience and expertise advising clients on Chapter 5C and Chapter 7 of the Corporations Act, assisting to establish funds (including property funds, equity trusts, mortgage funds, cash management trusts, fixed interest trusts, trusts with infrastructure assets, private equity funds and hedge funds) and implement compliance and governance systems and procedures to meet the obligations under the Corporations Act.

If you would like further information about these structures or when an investment vehicle should be structured as a venture capital limited partnership under the *Venture Capital Act 2002*, please contact:

- Nick Humphrey, Partner