

**SUBMISSION**

**FROM THE NEW ZEALAND PRIVATE  
EQUITY & VENTURE CAPITAL  
ASSOCIATION**

**FINANCIAL SERVICE PROVIDERS (PRE-  
IMPLEMENTATION ADJUSTMENTS) BILL  
2009**

**25 MARCH 2010**



## **About the NZVCA**

1. This submission has been prepared by the New Zealand Private Equity & Venture Capital Association (NZVCA).
2. The NZVCA is a not-for-profit industry body committed to develop a world-best venture capital and private equity environment for the benefit of investors and entrepreneurs in New Zealand. Its core objectives include the promotion of the industry and the asset class on both a domestic and international basis. NZVCA members cover the whole spectrum of investment in New Zealand private enterprise, including angel investment, seed and early-stage venture capital through to development capital and private equity (including management buy-outs and buy-ins).
3. We would like the opportunity to appear before the Committee and speak on these submissions. Please contact Colin McKinnon, Executive Director, Level 6 Affco House, 12-26 Swanson Street, to coordinate this. Colin's direct number is 09 302 5218 alternatively he can be reached by email at [colin.mckinnon@nzvca.co.nz](mailto:colin.mckinnon@nzvca.co.nz).
4. The NZVCA supports the submissions made on behalf of the Angel Association.

### *Contact details*

5. The NZVCA would be happy to discuss the issues raised in this paper further. To engage further, please contact:
  - (a) Colin McKinnon (details above); or
  - (b) Michael Pollard (Partner, Simpson Grierson) on 09 977 5432 or [michael.pollard@simpsongrierson.com](mailto:michael.pollard@simpsongrierson.com)

## Executive Summary

6. The proposed regime encompassed within the Financial Advisers Act 2008 and the Financial Service Providers (Registration and Dispute Resolution) Act 2008 (**Proposed Regime**) appears to capture various processes currently adopted in the private equity and venture capital models. As a result it imposes a new layer of regulation on a sector of the market which, to all intents and purposes, has the ability and information to protect itself, without providing any real benefit to the parties involved.
7. The Proposed Regime needs to be appropriately tailored to reflect the investment model applicable to private equity and venture capital investment.
8. The NZCVA believes that the most appropriate response in context is to create some form of wholesale exemption, exempting transactions outside the public forum from the Proposed Regime.
9. Should this approach not be considered appropriate from a policy standpoint, then it is suggested that the scope of the regime be limited so that it would not apply to the types of advice or transactions described in this submission.
10. We also suggest that the Proposed Regime provides a suitably flexible mechanism for obtaining necessary exemptions. This is particularly important having regard to the number of changes currently being considered by government and the difficulties associated with consultation in these circumstances.

## Body of Submission

### *Introduction*

11. The NZVCA supports the need to make further amendments to the Proposed Regime.
12. In its view, this legislation needs to be appropriately tailored to reflect the investment model applicable to private equity and venture capital investment.

### *Background description of Private Equity and Venture Capital Model*

13. Private equity and venture capital funds are pooled investment vehicles used for making investments, typically in the private capital markets<sup>1</sup>. These funds are typically limited partnerships with fixed lives which attract investment capital from institutional investors such as pension funds, from high net worth or experienced individuals and from other persons exempted the core requirements of public offer legislation in the jurisdictions in which they raise capital (including New Zealand<sup>2</sup>). These investors invest through private equity and venture capital funds with a view to gaining investment to the private company asset class – as opposed to pursuing direct investment. Some funds have also raised funds using registered prospectuses.
14. Funds are raised and managed by the investment professionals of a specific private equity or venture capital fund (**sponsor**). The term sponsors spans the various seed investment funds right through the larger offshore and NZ buy-out funds. At inception, investors make unfunded capital commitments to the sponsor, which are then drawn over the term of the fund as committed capital is invested.
15. The distinction between venture capital and private equity is largely irrelevant for the purposes of this submission, but by way of background, venture capital funds tend to focus on investments which are at an earlier stage in their life cycle than the more mature businesses which private equity focuses on.
16. Typically, funds have a limited lifespan and are limited by their constituting documents from entering into investments resulting in concentration risk. We will explain the relevance of this below.
17. Set out below is a description of a relatively typical investment scenario and where issues might be considered to arise under the Proposed Regime:
  - (a) An opportunity is identified by the sponsor, and following due diligence, the opportunity and sponsor's conclusions are presented to an investment committee (**IC**) comprising representatives of the sponsor together with, in some cases, specialist consultants who work alongside the sponsor (such as scientists or other industry experts – persons to whom an exemption from the Securities Act would invariably apply).  
  
(Sponsors typically also have an investment advisory committee (**IAC**) comprising key (representative) investors. Representative investors are

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<sup>1</sup> Some funds hold securities in public companies

<sup>2</sup> The exemptions used are typically those in sections 3(2) and 5(2CB) of the Securities Act

almost always institutional - being the key investors in the fund. The role of the committee varies from fund to fund but usually includes monitoring the manager's performance and conflicts of interest, reviewing investment policy and in some cases, providing limited strategic advice on investments to be undertaken. This committee in principle, serves a check and balance and governance function.)

- (b) In the course of relevant IC and IAC meetings, recommendations and guidance (arguably in the nature of "financial advice" for the purposes of the Proposed Regime) is communicated between the sponsor and other members of the relevant committees.
  - (c) Funding of the transaction proceeds by the Sponsor requiring investors to put up the required portion of committed capital. No financial advice is communicated in this context.
  - (d) The committed capital is then invested on behalf of the underlying investors.
18. Occasionally, it is necessary for sponsors to revert to underlying investors to approve a transaction – this might occur when the typical duration of a fund or concentration risk thresholds are affected (if these types of decisions have not been allocated to the IAC in the fund documentation). In the course of relevant meetings, recommendations and guidance (arguably in the nature of "financial advice" for the purposes of the Proposed Regime) may be communicated between the sponsor and investors.
19. Also note that some sponsors participate in "co-investment" arrangements – such as those existing between various funds and the NZ Government funded New Zealand Venture Investment Fund (**VIF**). These dialogue arising between the sponsor and VIF in connection with any potential investment is likely to comprise financial advice for the purposes of the Proposed Regime.
20. Current financial advisers legislation is generally considered inapplicable to the activities carried out by private equity and venture capital funds on the grounds that it recognises the wholesale / retail distinction exempting advice given to persons exempt from section 3 (other than 3(2)(a)(a)) of the Securities Act.

#### *NZVCA Concerns*

21. The key concern of the NZVCA is that the Proposed Regime ignores the wholesale and retail distinction that underpins New Zealand's securities laws and imposes a new layer of regulation on a sector of the market which, to all intents and purposes, has the ability and information to protect itself.
22. While the NZVCA agrees that there is an inherent benefit in improving the quality of financial advice which is provided to members of the public, for wholesale transactions the Proposed Regime would result in new compliance obligations and costs without providing any real benefit to the parties involved. There is a real concern that this additional cost may undermine the viability of some of the very early stage seed funds.
23. By way of example, whilst there are grounds to argue to the contrary in some cases, a financial adviser service might be considered to arise in the following contexts:

- (a) During the exchange of views by committee members during an IC or IAC meeting. Note that:
- (i) the application of the regime to committee decision making processes generally is not clear. The regime does not make it clear whether there needs to be a "third party" recipient of advice. The distinction created in the Proposed Regime between employee and employer seems to suggest this is not the case, however, there should perhaps be a distinction, for instance, between financial advice provided on an arm's length basis and deliberative discussions between multiple people in a committee context;
  - (ii) the employee exemption is unnecessarily restrictive and does not encapsulate other forms of service provider who provide an "internal" service – as would be the case with the IC meeting at the very least; and
  - (iii) the amendment proposed in the Financial Service Providers (Pre-Implementation Adjustments) Bill (SOP 113) clause 8(1AD) is unlikely to cure any concerns here:
    - members of the IC (and possibly the IAC) are not likely to be regarded as providing an "investment management service" – rather, there is a concern that deliberations on such committees might be regarded as financial advice regarding that a decision regarded as an investment management service; and
    - it would be preferable to have some clarity around the intended scope of the meaning of "issuer", for the purposes of the definition of "product provider". As drafted, this definition would extend to "issuers" who issue securities to persons not caught by the Securities Act and who therefore do not need a registered prospectus and investment statement. We are comfortable with this conclusion – it is consistent with our desire for a distinction between wholesale and retail transactions, however clarity would be preferable.
- (b) Potentially, as a result of the investment by sponsors of capital committed by underlying investors (structure dependent).

#### *Possible Solutions*

24. The NZCVA believes that the most appropriate response in context is to create some form of wholesale exemption, exempting transactions outside the public forum from the rigours of the regime. As mentioned above, we believe that including an exclusion from the regime for the wholesale market would decrease the compliance obligations and costs for this sector of the market without being a disadvantage to those persons who receive the advice. We acknowledge a policy desire to ensure standards are upheld in financial advisory services. We would suggest that further consideration is given to dealing with these by excluding specific forms of financial advice from any wholesale exemption.

25. This "public" / "private" distinction is recognised in section 48 of the Financial Services Providers (Registration and Dispute Resolution) Act 2009 (**FSRA**) which prescribes that "every financial service provider must be a member of either an approved dispute resolution scheme, or a reserve scheme, in respect of a financial service provided to the public". The term public is described in section 49 of the FRSA which seems to adopt some of the tests in section 3 of the Securities Act. We consider that this distinction should be applied in relation to the whole regime rather than the requirement to be a member of an approved dispute resolution scheme. We also consider that the definition of the public should be consistent with that in section 3 of the Securities Act but that the key section 5 exclusions should also be applicable.
26. Should this approach not be considered appropriate from a policy standpoint, then we suggest that the scope of the regime be limited so that it would not apply to the types of advice or transactions described in this submission. Creating an exclusion to this effect would recognise the importance of the angel associations, private equity and venture capital funds in developing New Zealand's private capital markets and providing funds for developing companies, and the level of "sophistication" of the investors who participate in such associations and funds.

#### *Exemption Powers*

27. Finally, it is important that the regime provides a suitably flexible mechanism for obtaining relevant exemptions. As drafted, the regime will see a significant shift in financial advisers law in New Zealand and it is inevitable that there are unintended consequences or necessary exceptions. These need to be able to be dealt with efficiently.
28. As presently drafted the Financial Advisers Act only permits the Securities Commission to grant exemptions from a disclosure obligation or obligations, other changes to the law are required to be made by way of regulation. Given the breadth of Proposed Regime, we believe the Commission should be able to grant exemptions from compliance. The Commission already has similar exemption powers under the Securities Act and the Financial Reporting Act.