

CLAYTON UTZ

A Guide to the Law of
Securitisation in Australia

Fourth Edition

A Guide to the Law of Securitisation in Australia

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Introduction

A Guide to the Law of Securitisation in Australia

Australia has one of the world's most active securitisation markets. Over \$160 billion of securities are outstanding and approximately \$40 billion of securities are issued annually. Almost all major issuers have established Euro and Global MBS programs and Australia is now reputed to be the third largest MBS market in the world. Australia is also an exporter of its securitisation expertise, with a number of prominent, domestically-based investment banks arranging and structuring securitisation transactions in Asia and New Zealand.

The law plays a pivotal role in the structure and regulation of many securitisation programs. As a result, to succeed in today's environment, a securitiser must have an understanding of the key aspects of the law relating to securitisation. In this publication we give you an overview of these key aspects.

This publication deals with the following major areas:

- Section 1 examines the legal nature of securitised instruments used in the Australian marketplace.
- Section 2 reviews the regulatory regime applying to those securities under the *Corporations Act*.
- Section 3 analyses the disclosure obligations for information memorandums used by the securitisation industry.
- Section 4 deals with the stamp duty implications of securitisation transactions, with particular focus on the NSW *Duties Act*.
- Section 5 reviews the taxation position of securitisation structures under the *Income Tax Assessment Act*, the Interest Withholding Tax exemptions and the Goods and Services Tax (GST) laws and also outlines some of the proposed changes to the taxation regime announced by the Government.
- Section 6 examines the implications of the Consumer Credit Code for securitisation.
- Section 7 reviews the requirements of Prudential Standard APS 120 governing the role of banks, building societies and credit unions in securitisations and some of the pertinent provisions of the *Banking Act*.
- Section 8 provides a brief review of the law of set-off which is particularly important in the context of securitisations by deposit-takers such as banks, building societies and credit unions.
- Section 9 examines the insolvency provisions relating to special purpose vehicles.

- Section 10 analyses a number of issues concerning trustee debt securities in securitisation programs.
- Section 11 considers a number of issues relating to the ASX Listing Rules for debt securities.
- Section 12 provides an overview of the legal aspects of the Austraclear System.
- Section 13 examines commercial mortgage-backed securities in Australia.
- Section 14 reviews the rationale and processes of synthetic securitisations.

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A Guide to the Law of Securitisation in Australia – Fourth Edition.

Written by members of the Clayton Utz securitisation team.

This publication states the position as at 1 April 2005.

It is intended to provide general information on the law of securitisation in Australia and is current at the time of printing. The contents do not constitute legal advice and should not be relied upon as such. Specialist legal advice should be sought in particular matters. Persons listed may not be admitted in all jurisdictions. We are happy for you to reproduce this material for personal and non-commercial purposes, or for purposes permitted by law, provided any reproduction is unaltered, shows the date of first publication and an attribution of source is included. If you wish to make any other use of this material, you must have our prior written permission. To ask for permission or for further information, please contact the webmaster@claytonutz.com.

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1 General overview of the nature of securitised instruments

1.1 Introduction

This section briefly reviews the nature of securitised instruments and the types of issuers in the Australian marketplace. The analysis proceeds using the market's distinction between *equity* and *debt* securities.

1.2 Equity securities

An investor in an equity security issued through a securitisation structure holds a beneficial interest in the underlying mortgage or asset pool. Although the instrument may be described as a bond or note, strictly speaking an investor receives a unit in a unit trust entitling it to a share of the income and capital of the trust assets. The unit is structured to replicate the qualities of a debt instrument. Measures are put in place to ensure that investors receive, on nominated dates, an amount equivalent to interest (ie. a distribution of income) and a repayment of principal (ie. a redemption of principal).

The initial securitisation structures in Australia, such as the early FANMAC Trusts, were based upon equity securities. However, the then requirements of the former Insurance and Superannuation Commission (ISC) favoured debt securities over equity securities. This resulted in these structures being modified so that investors held a debt rather than an equity security. The ISC requirements no longer apply, however, new stamp duty impediments have developed that prevent the Australia-wide utilisation of equity securities. The impediments are briefly discussed in section 4.

1.3 Debt securities

1.3.1 Overview of debt securities in Australian securitisations

Under a debt security, the issuer allots instruments known as bonds, notes or commercial paper. Unlike equity securities, investors do not have an ownership interest in the underlying mortgage or asset pool. Instead, they hold a promise by the issuing vehicle to pay interest and principal. This is typically combined with a security interest over the securitised assets through a charge given by the issuing vehicle to a security trustee for the benefit of investors (and often for others who provide supports for the structure). Such debt securities can be structured on a bullet maturity or pass-through basis and as floating rate or fixed rate securities.

1.3.2 The issuers of debt securities

Debt securities overseas tend to be issued only by special purpose corporations. This also occurs in Australia, but here trustees also issue debt securities (this is particularly the case for Australian mortgage securitisations). The securitised assets are held on trust by the trustee and its liability under the debt securities is limited to the proceeds from the underlying assets that are available to pay the securities in accordance with the relevant trust deed.

The use of trusts to issue debt securities is largely confined to Australia. This in turn has led to Australian securitisers and their advisers dealing with a series of unique trust issues connected with this development. Some of these are discussed in section 10.

1.3.3 The form of debt securities

Debt securities are typically issued in one of two forms.

Physical security

Under this, an investor holds an instrument which itself contains the issuer's debt obligation. The instrument can be transferred by delivery or endorsement. Promissory notes are an example of this type of debt security. While physical securities were once common in the securitised market, they are less so now for three reasons. The first is that the preparation and issue of individual securities are relatively cumbersome when compared to other methods, particularly the electronic issue and trading of securities within the Austraclear system. The second reason is that the requirement of the trustees that their liability on such securities be limited, and the similar (but slightly different) requirement imposed by the rating agencies in relation to segregated corporate issuers, mean that it is increasingly difficult to satisfy the strict legal requirements for such securities to qualify as promissory notes under the *Bills of Exchange Act* 1909. This is discussed in further detail in section 10. Finally, section 126 of the *Income Tax Assessment Act* 1936 imposes a domestic withholding tax on interest paid by a company on a debenture payable to the bearer where the company does not give the Commissioner the name and address of the holder of the debenture. This tax discourages the use of bearer securities in Australia.

Registered securities

The other type of debt security is known as a registered security. The actual debt obligation of the issuer is constituted in a separate document from the security itself. In the separate document, the issuer promises to pay the persons who from time to time appear on a register as holders of the relevant securities.

An investor in turn receives an acknowledgement in writing from the person maintaining the register, confirming that the investor appears in the register as the holder of particular securities.

Under this type of arrangement, the investor does not hold a true debt instrument. However, little (if any) legal importance turns on the distinction. It is simply another accepted method of issuing debt securities. A transfer of a registered security occurs by the transferor and the transferee executing a Transfer and Acceptance Form and then lodging this with the registrar. Sometimes (depending on the requirements of the underlying documents), this must be accompanied by the original confirmation. Although this is not strictly necessary, it is a desirable practice to avoid fraud.

The transfer is effective as between the transferor and the transferee upon the execution of the Transfer and Acceptance Form and payment by the transferee of the purchase price (and upon performance of any other conditions precedent that may be stipulated by the parties as part of the transfer). But, as far as the issuer is concerned, the transfer does not become effective until the transferee is noted in the register as the holder of the securities. Until this occurs, the issuer is entitled to only recognise the transferor as the holder and all payments, notices, etc. are made in the interim to the transferor.

In Australia, almost all securitised instruments are structured as registered securities. As most securities are held and traded through Austraclear, typically the register of an issuing vehicle will show Austraclear as the only holder of its securities. Austraclear then keeps its own record of those on whose behalf it is holding those securities in the Austraclear System.

1.3.4 The enforceability of registered securities

At general law, there is a principle known as privity of contract. This means that only the parties to a contract can enforce it. With registered securities, investors are not a party to the instrument creating the debt obligation represented by their securities. This then raises the issue of how do they enforce the issuer's promise to pay interest and principal, when they cannot satisfy the privity of contract rule?

Where the issuer is a special purpose corporation, a note trust deed or a deed poll is usually used. Both of these employ exceptions to the privity rule. Under a note trust deed, the issuer covenants in favour of a note trustee that it will pay interest and principal on its debt securities. This covenant is held on trust by the note trustee for the benefit of the holders of the registered securities from time to time.

Although the holders of the securities are not parties to the note trust deed and so cannot directly enforce the issuer's covenant, they are beneficiaries of the trust and can require the note trustee to do so.

Under a deed poll, the issuer's covenants are made in favour of the registered security holders from time to time. The exact legal nature of a deed poll has been the subject of much legal debate but, notwithstanding this, deeds poll are frequently used in the market.

The position is more interesting where the issuer is a trustee. In almost all Australian securitisations, the trustee's promise to pay interest and principal on its debt securities is contained in the trust deed. However, the trustee's obligations in a trust deed usually can only be enforced by the beneficiary (or beneficiaries) of the relevant trust. How then do the holders of the securities have the benefit of the trustee's promise to pay interest and principal on their securities?

The answer lies in the fact that with these structures there is always a security trust deed. Under the security trust deed, the issuing trustee covenants in favour of a security trustee that it will pay interest and principal on the registered securities in accordance with the trust deed. As with a note trust deed arrangement, the security trustee holds the benefit of this covenant on trust for the security holders. They can enforce the terms of their debt securities through the security trust deed.

If in the future there is ever a proposal for a trustee to issue unsecured registered securities, the legal basis for their enforceability will need to be examined at that time in greater detail. In particular, it may be necessary to put in place a deed poll or a note trust deed to address this issue.

1.4 Conclusion

The securities held by investors in the Australian securitised market tend to be exclusively debt securities rather than equity securities. The former are issued either by special purpose corporations or by trustees. Where a special purpose vehicle issues debt securities, traditional legal forms are used. However, the issue of debt securities by trustees, which is largely confined to the Australian market place, raises a number of unique issues. These are canvassed in section 10.

The next section of this publication examines the classification and regulation of debt and equity securities under the *Corporations Act*.

2 The *Corporations Act* 2001

2.1 Introduction

The *Corporations Act* potentially affects securitisation structures in the following ways:

- it regulates many debt and equity issues (which is the subject of section 2.2); and
- it controls the participants in the Australian securities industry (which is described in section 2.3).

In addition, the *Corporations Act* prescribes a series of disclosure requirements on certain securities issues. In combination with the *Trade Practices Act* 1974 and the *Australian Securities and Investment Commission Act* 2001, it also imposes civil liability for a defective information memorandum (both of these subjects are dealt with in section 3).

2.2 The classification of securitised instruments under the *Corporations Act*

The application of the *Corporations Act* to a given type of securitised instrument depends upon whether it is a debenture or an interest in a managed investment scheme.

2.2.1 Debentures

The definition of a debenture

Section 9 of the *Corporations Act* defines a “debenture” of a body to mean, subject to a number of exceptions, a “chase in action that includes an undertaking by the body to repay as a debt money deposited with or lent to the body.”

The *Corporations Act* specifically excludes from the definition of a debenture an undertaking to repay money lent by a person to a body where:

- “(i) the person lends the money in the ordinary course of a business carried on by that person; and
- (ii) the body receives the money in the ordinary course of carrying on a business that neither comprises nor forms part of a business of borrowing money and providing finance.”

This exclusion is very wide and potentially extends to the securities of many securitisation programs. This is because the securities are typically first acquired by professional dealers who lend money in the ordinary course of their business (requirement (i) above) and often the SPV issuing the instrument will not be in the business of “providing finance” (which is narrowly defined in the *Corporations Act*). This means that many securitisation instruments will not be debentures and hence unregulated under the *Corporations Act*, unless they fall within the definition of a “managed investment scheme” (see sections 2.2.2 and 2.2.3).

There are two further relevant exceptions to the definition of a debenture. These are a bill of exchange (for any amount) and a promissory note (having a face value of at least \$50,000). The implications of these exceptions are discussed in section 2.2.5.

The statutory requirements for debentures

Chapter 2L of the *Corporations Act* regulates the offer of debentures by a body in Australia if, amongst other things, the offer needs disclosure to investors in the manner regulated by Chapter 6D of the *Corporations Act* (see section 2.2.4). Chapter 2L, when it applies, requires the offering body to settle a trust deed relating to the debentures and to appoint a qualified institution to act as trustee for the debenture holders. The trust deed must contain minimum requirements designed to safeguard the interests of debenture holders. In addition, statutory duties are imposed upon the offering body and the trustee regarding the performance of their respective functions. The Chapter also regulates the description that can be given to debentures and requires the trustee to give the Australian Securities and Investment Commission (ASIC) quarterly reports relating to the debentures.

2.2.2 Interests in a managed investment scheme

Section 9 of the *Corporations Act* defines an interest in a managed investment scheme as a right to benefits produced by the scheme (whether the right is actual, prospective or contingent and whether it is enforceable or not).

Section 9 of the *Corporations Act* in turn defines a managed investment scheme to include, subject to certain exceptions, a scheme that has the following features:

- “(i) people contribute money or money’s worth as consideration to acquire rights (interests) to benefits produced by the scheme (whether the rights are actual, prospective or contingent and whether they are enforceable or not);
- (ii) any of the contributions are to be pooled, or used in a common enterprise, to produce financial benefits, or benefits consisting of rights or interests in property, for the people (the members) who hold interests in the scheme (whether as contributors to the scheme or as people who have acquired interests from holders);
- (iii) the members do not have day to day control over the operation of the scheme (whether or not they have the right to be consulted or to give directions)”.

An interest in a managed investment scheme clearly is defined very widely. If there were no limitations on the concept, it would embrace any type of investment contemplated in the business community. Therefore, in order to make the definition, and the associated regulatory scheme, workable, the *Corporations Act* has had to specify a number of exclusions. These include the issue of debentures by a body corporate.

The purpose of excluding debentures is to ensure that they are regulated only by Chapter 2L of the *Corporations Act* (see above) and not also by the managed investment scheme sections.

There is a real prospect that a structured instrument that is not a debenture will qualify as an interest in a managed investment scheme. This follows from two factors: first, from the width of the definition itself; secondly, the body of case law confirming that a debt security issued to investors in circumstances where the money is then reinvested and investors are promised a certain rate of interest, and repayment of principal, satisfies the definition of a managed investment scheme.

Interestingly, bills of exchange and promissory notes are no longer specifically excluded from the definition of managed investment scheme, as was the case in respect of the definition of participation interest under the former regime. For some of the implications of this, see section 2.2.5.

The statutory requirements for interests in a managed investment scheme

Chapter 5C of the *Corporations Act* regulates the issue of interests in managed investment schemes. Every registered managed investment scheme must have a responsible entity, being the person who operates the scheme and performs the functions which are conferred upon it by the scheme's constitution and the *Corporations Act*. The Chapter sets out the statutory responsibilities of a responsible entity and its officers to the members of the scheme. It also provides for the registration with the Australian Securities and Investments Commission (ASIC) of the governing constitution of the managed investment scheme and its compliance plan, which must contain the measures taken, or to be taken, by the responsible entity to ensure compliance with its constitution and the *Corporations Act*.

2.2.3 The extent to which securitisations involve debentures and interests in a managed investment scheme

As can be seen from the above, some securitised instruments may be debentures, others may be interests in a managed investment scheme, while others may be neither. Securitisations based on these different instruments might be regulated under Chapter 2L, Chapter 5C or may be completely unregulated.

However, in order to simplify the analysis in this publication, it is assumed that a debt security issued by a corporation is a debenture, but it is important to appreciate that this may often not be the case.

It is clear that equity securities issued by a trustee (ie. units in a unit trust) are interests in a managed investment scheme (eg. see *Attorney General of NSW v Australian Fixed Trusts* [1947] ACLC 40-100), which was decided under the previous regime, but the reasoning of which continues to apply to the current definition of a managed investment scheme.

As can be seen from the above, bills of exchange (for any amount) and promissory notes (for a face value in excess of \$50,000) are not debentures. Therefore, securitisations based on these are not regulated by Chapter 2L. However, securitisations based on bills of exchange or promissory notes have the potential to be regulated under Chapter 5C as managed investment schemes.

A more difficult issue is the proper classification of debt securities issued by trustees. On their face, they should be regulated in the same manner as for other debt securities (ie. on the basis that they are debentures). This approach, however, is complicated by a draft Policy Statement issued in July 1992 by the Australian Securities Commission (ASC), the predecessor to ASIC. In it the ASC felt that debt securities issued by trustees in securitisations were not debentures and should be regulated by a hybrid approach blending the then Divisions 4 and 5, which now correspond to Chapters 2L and 5C.

In most cases, the proper classification of a securitised instrument as a debenture, or an interest in a managed investment scheme, has no immediate commercial ramifications. This is because the regulatory regimes imposed by Chapters 2L and 5C do not apply where there is an offer of securities that does not need disclosure under Chapter 6D.2. As will be seen from the next section, the effect of this is that almost the entire securitisation industry is exempt from the application of these Chapters of the *Corporations Act*. The only exception is that all issues of debentures need to comply with the register provisions of the *Corporations Act* (sections 168(1)(c) and 171). However, these are not onerous and can be easily satisfied.

Recently however, there have been a number of "retail" securitisation issues. In these cases it is important to determine the proper classification of the securities as debentures, interests in a managed investment scheme or neither. As can be seen from the previous analysis, some arbitrary results can arise.

2.2.4 Offers that do not need disclosure: Their application to securitisations

Under the *Corporations Act*, a prospectus must be registered with ASIC, and must comply with the statutory requirements in relation thereto, in connection with every offer of securities, except where the *Corporations Act* provides that the offer does not require disclosure to investors.

Debentures fall within the section 761A definition of a security that applies for the purposes of Chapter 6D. Section 708 specifies those offers of securities that do not need disclosure to investors. There are a number of types of offers that fall under section 708 that could, conceivably, be relevant to a securitisation depending on the particular circumstances. Most transactions are structured to utilise section 708(8). This provides that an offer of securities does not need disclosure to investors if:

“(a) the minimum amount payable for the securities on acceptance of the offer by the person to whom the offer is made is at least \$500,000; or

(b) the amount payable for the securities on acceptance of the offer by the person to whom the offer is made and the amounts previously paid by the person for the body’s securities of the same class that are held by the person add up to at least \$500,000.”

In relation to the exemption referred to in paragraph (a) it is important to appreciate that the amount actually subscribed must be \$500,000 or more. A security with a face value of \$500,000, but which is issued at a discount, will not qualify. The reason is that the minimum amount payable by an investor will then be less than \$500,000.

The exemption referred to in paragraph (b) is also important as it allows investors to top up their existing investments with additional securities of less than \$500,000, provided that the amount then paid by that investor, when combined with the amounts previously paid for all securities of the class offered, is at least \$500,000.

In relation to securitisations where the securitised instrument is classified as a managed investment scheme and the acquirer is a retail client, a product disclosure statement must be registered with ASIC and must comply with the statutory requirements in Part 7.9 of the *Corporations Act*.

2.2.5 Bills of exchange and promissory notes

As indicated above, a bill of exchange (for any amount) and a promissory note (with a face value of \$50,000 or more) is not a debenture for the purposes of the *Corporations Act*.

However, a bill of exchange or a promissory note may, depending on the relevant circumstances, constitute an interest in a managed investment scheme. For instance, the raising of part of the finance for a development project through the issue of promissory notes (with a face value of \$50,000) by two special purpose companies has been held to be a managed investment scheme (see *ASIC v Emu Brewery Mezzanine Ltd and Bayshore Mezzanine Pty Ltd* [2004] WASC 241). This is because the current definition of managed investment scheme does not expressly exclude bills of exchange and promissory notes, as was the case under the forerunner to that definition under the previous prescribed interests regime.

Accordingly, many of the advantages (which included the sale to members of the public without attracting the *Corporations Act*) that accrued to an issuer who structured a securitisation scheme based upon bills of exchange or promissory notes may no longer exist because such a securitisation can now be regulated by Chapter 5C of the *Corporations Act*. However, importantly, these types of securitisations will not require registration under the managed investments regime if they are structured so as to fall within a class of offering that does not need disclosure to investors (see above).

2.3 The regulation of participants in the securities industry

2.3.1 Financial services reform

The new financial services reform (FSR) provisions of the *Corporations Act* commenced on 11 March 2002.

FSR is a wide-ranging reform designed to regulate the whole of the financial services industry. Its genesis was in the Financial System Inquiry in 1997 (usually referred to as the Wallis Inquiry after its chairman Mr Stan Wallis). One of the principal recommendations of the Wallis Inquiry was to replace the then piecemeal regulation of financial services, under which entities or products performing essentially the same function were often regulated in a significantly different manner, with a single regulatory framework. In the first stage of the implementation of the Wallis Inquiry recommendations, prudential regulation of entities such as banks, building societies, credit unions, life insurers, general insurers and certain superannuation funds were brought under the supervision of a single regulator, the Australian Prudential Regulation Authority (APRA).

(FSR) represents the second stage of the implementation of the Wallis Inquiry and has two principal aspects:

- the licensing of participants in the financial services industry; and
- a disclosure regime in relation to financial products.

As a general rule, the product disclosure regime only applies to participants in the retail market. The distinction between “retail” and “wholesale” for FSR purposes is set out in section 761G of the *Corporations Act* and is similar to the test in section 708 (discussed in section 2.2.4) in relation to the requirement to lodge a prospectus for an issue of securities. It includes that the provision of a financial product will not be “retail” if the price of the financial product equals or exceeds \$500,000 (section 761G(7)(a)).

As almost all securitisations in Australia occur in the wholesale market (see section 2.2.4), participants in the securitisation industry will usually only need to consider the new licensing regime.

2.3.2 When is a licence required?

Previously the *Corporations Act* only required licences to be obtained by persons who carried on a securities business (who were required to have a dealer’s licence) or an investment advice business (who were required to have an investment adviser’s licence).

The FSR amendments have significantly widened the class of persons in the financial services industry required to obtain a licence to operate their business.

Section 911A(1) of the *Corporations Act* requires that an Australian Financial Services Licence (AFSL) be obtained by a person who “carries on a financial services business” in Australia. Section 911D provides that a financial services business is taken to be carried on in Australia if in the course of the business “the person engages in conduct that is intended to induce people in Australia to use the financial services the person provides or is likely to have that effect”.

The term “business” is not defined in the FSR provisions (although there is some guidance to the meaning of carrying on a business in Division 3 of Part 1.2 of the *Corporations Act* which is also applicable to the question under FSR). In particular, it is not always clear when a transaction or a series of transactions will constitute a business – but there is case law authority that, in some circumstances, even a single transaction can constitute a “business”.

A “financial services business” is defined in section 761A of the *Corporations Act*, as “a business of providing financial services.” Section 766A in turn sets out the circumstances in which a person will “provide a financial service”.

In determining whether an AFSL is required for a participant in the securitisation industry, there are essentially four questions to be considered:

- first, does the person do anything in relation to a “financial product”?
- secondly, is what the person does the “provision of a financial service”?
- thirdly, will the person have the benefit of a class order issued by ASIC granting relief from the requirement to be licensed?
- fourthly, will the person have the benefit of an exemption from the requirement to be licensed?

Each of these issues is considered in turn in the following sections.

2.3.3 What is a financial product?

Section 763A of the *Corporations Act* provides that a financial product is a facility through which, or through the acquisition of which, a person does one or more of the following:

- makes a financial investment;
- manages financial risk; or
- makes non-cash payments.

Each of these terms is further defined. Section 764A contains a list of specific products which will be financial products whether or not they fit the general definitions. Section 765A in turn lists specific products that will not be financial products and overrides both sections 763A and 764A. The following are examples of some products, relevant for securitisation, that will be financial products:

- shares;
- debentures;
- bank accounts;
- derivatives;
- insurance policies (with some exceptions);
- in some limited cases, the underlying receivables being securitised.

2.3.4 Provision of a financial service

Section 766A of the *Corporations Act* states that a person provides a financial service if they:

- provide financial product advice;
- deal in a financial product;
- make a market for a financial product;
- operate a registered scheme; or
- provide a custodial or depository service.

All these terms are further defined in the *Corporations Act*. Of particular relevance for participants in the securitisation industry are: the provision of “financial product advice”, “dealing in a financial product” and “providing a custodial or depository service”.

Financial product advice

Section 766B provides that financial product advice means a recommendation or a statement of opinion or a report of either of those things that:

- *is intended to influence a person ... in making a decision in relation to a particular financial product or a class of financial products or an interest in a particular financial product or class of financial products; or*
- *could reasonably be regarded as being intended to have such an influence.*”

This will be relevant for persons who take responsibility for information memorandums for the sale of securitised instruments or who participate in roadshows marketing their sale.

Dealing in a financial product

Dealing in a financial product is widely defined in section 766C(1) of the *Corporations Act* to include “applying for or acquiring a financial product, issuing a financial product, underwriting securities, varying a financial product or disposing of a financial product”.

Arranging for a person to engage in any of the conduct referred to above is also dealing in a financial product (section 766C(2) of the *Corporations Act*). This is particularly relevant for managers of securitisation vehicles who will usually arrange for the issuer to deal in financial products.

Pursuant to section 766C(3) of the *Corporations Act*, a person is taken not to deal in a financial product if the person deals in the product on their own behalf (whether directly or through an agent or other representative) unless the person is an issuer of

financial products and the dealing is in relation to one or more of those products. In the case of derivatives however, each party to the derivative is deemed to be its issuer – so section 766C(3) will not assist.

Providing a custodial or depository service

Pursuant to section 766E, “a person (the provider) provides a custodial or depository service to another person (the client) if, under the arrangement between the provider and the client, or between the provider and another person with whom the client has an arrangement ... a financial product or a beneficial interest in a financial product, is held by the provider in trust for ... the client or another person nominated by the client”.

Accordingly, any person who holds financial products on trust for another person will be providing a custodial or depository service. This will apply to, amongst others, trustees of special purpose trust securitisation vehicles.

2.3.5 Securitisation Class Orders

Following industry lobbying to ASIC in relation to the requirement to obtain an AFSL in connection with securitisation transactions, in December 2003 ASIC issued a temporary class order (Class Order [CO 03/1098] *Securitisation special purpose vehicles and securitisation managers*) granting temporary relief to both securitisation special purpose vehicles and managers. The relief was only temporary to enable ASIC to consult with the securitisation industry about the form and appropriateness of permanent relief. ASIC issued a consultation paper in August 2004 and undertook a consultation process with the securitisation industry.

In January 2005, ASIC issued a permanent class order in relation to securitisation (Class Order [CO 04/1526] *Securitisation special purpose vehicles*). This class order grants relief from obtaining an AFSL to special purpose companies and special purpose trustee companies involved in securitisation transactions, subject to certain conditions.

No relief is granted under the permanent class order to securitisation managers and as a result, at the time of writing, those relying on the temporary class order have until 30 June 2005 to obtain an appropriate AFSL.

2.3.6 Exemptions

Section 911A(2) and the *Corporations Regulations* 2001 provide a variety of exemptions from the requirement that a person who provides a financial service hold an AFSL. The exemptions, however, are often narrowly or inexpertly drafted and do not always achieve their apparent objective.

Some of the more relevant exemptions for securitisation include:

- the dealer exemption – section 911A(2)(b) provides an exemption for a person (the product provider) who provides a service which is the issue, variation or disposal of a financial product by the product provider pursuant to an arrangement with a person who has an AFSL, where the holder of the AFSL has made an offer on behalf of the product provider and product provider issues, varies or disposes of the financial products if the offer is accepted.
- the hedging exemption – regulation 7.6.01(1)(m) provides that an AFSL is not required with respect to the provision of a financial service where:
 - *the service consists only of ... dealing in derivatives;*
 - *the service does not involve making a market in derivatives;*
 - *the dealing is entered into for the purpose of managing a financial risk that arises in the ordinary course of a business;*
 - *the person does not deal in derivatives ... as a significant part of the person's business; and*
 - *the dealing is entered into on the person's behalf."*
- the own debentures/securities exemptions – section 766C(4) exempts dealings in one's own securities from the definition of "dealing". This exception in turn however, will not apply to certain investment vehicles (but as a general rule will apply to securitisation vehicle issuers where the issue is wholesale).

A number of other exemptions can also be relevant to participants in the securitisation industry.

2.3.7 Consequences of a failure to have an AFSL

Section 925A of the *Corporations Act* provides that if a party is required to but does not hold an AFSL, any agreement which it has entered into with any other party in the course of carrying on a financial services business is rescindable by the other party.

In addition, a breach of section 911A of the *Corporations Act* is an offence pursuant to section 1311(1), the penalty of which may include a fine of up to 200 penalty units (\$22,000) or imprisonment of up to two years or both.

2.4 Conclusion

The provisions of the *Corporations Act* dealing with the securities market have become increasingly convoluted over the years to the extent that the rationale for many provisions, and in particular of definitions of certain financial instruments such as "debentures" and "managed investment schemes", seems to have been lost. The new FSR provisions add a further layer of complexity and added compliance costs for industry participants. They can be particularly burdensome for foreign entities that undertake a number of discrete transactions in Australia without establishing an office (but who may nevertheless require an AFSL or be required to establish to ASIC's satisfaction that they are adequately regulated in their home jurisdiction).

The next section of this publication examines the disclosure and civil liability provisions under the *Corporations Act*, the *Australian Securities and Investment Commission Act* and the *Trade Practices Act* for information memorandums used by the securitisation industry.

3 The disclosure and civil liability regimes for information memorandums

3.1 Introduction

This section deals with two principal subjects:

- the positive disclosure obligations imposed by the *Corporations Act* for prospectuses – this is dealt with in section 3.2; and
- the civil liability under the *Corporations Act*, the *Australian Securities and Investment Commission Act* (the ASIC Act) and the *Trade Practices Act* (the TPA) for those who prepare and distribute a defective information memorandum – this is dealt with in section 3.3.

In relation to the first subject, as a general rule, the information memorandums used by the securitisation industry are not subject to the positive disclosure obligations of the *Corporations Act* (though, recently there have been a number of retail CDO issues that are governed by the *Corporations Act*). However, securitisers can be liable to compensate investors for omissions from their information memorandums. In analysing the material that should be included in an information memorandum to avoid this outcome, the positive disclosure obligations are, as the analysis below indicates, useful benchmarks.

3.2 The disclosure obligations of the *Corporations Act*

3.2.1 Overview

Section 727(1) of the *Corporations Act* provides that a person must not make an offer of securities (see section 2.2.4) or distribute an application form for an offer of securities if that offer needs disclosure to investors under Part 6D.2 unless a disclosure document has been lodged with ASIC.

Sections 706 and 707 provide that an offer of securities for issue and certain offers of securities for sale in the secondary market need disclosure to investors unless exempt from disclosure under section 708. The effect of this is that all offers of securities for issue (which is the most common situation for a securitisation) require a disclosure statement unless the offer can fit within an applicable section 708 exemption (most securitisations do this – see sections 2.2.4 and 3.2.4).

In the context of what constitutes an offer of securities for issue or an offer of securities for sale, section 700(2) provides that these include inviting applications for the issue of securities and inviting offers to purchase the securities, respectively.

Section 700(4) provides that Chapter 6D applies to offers of securities that are received in Australia, regardless of where any resulting issue, sale or transfer occurs. This has important implications for offers emanating offshore and received via the

internet, the telephone or by other electronic means in Australia. Such offers are regulated by the *Corporations Act* and thus are subject to the above provisions regarding when (and when not) a disclosure document must be prepared and lodged with ASIC.

3.2.2 Disclosure documents

The *Corporations Act* distinguishes between three types of disclosure documents. These are a “prospectus” (including a short form prospectus), a “profile statement” and an “offer information statement”.

The *Corporations Act* sets out the circumstances when each type of disclosure document is required (see sections 705, 709, 712 and 721) and their corresponding disclosure requirements.

The most demanding disclosure standard relates to a prospectus.

Section 710 of the *Corporations Act* provides that a prospectus in respect of an offer to issue a body's securities must contain all the information that investors and their professional advisers would reasonably require to make an informed assessment of:

- the rights and liabilities attaching to the securities offered; and
- the assets and liabilities, financial position and performance, profits and losses and prospects of the body that is to issue (or has issued) the securities.

The prospectus must contain this information only to the extent to which it is reasonable for investors and their professional advisers to expect to find the information in the prospectus. Further, the prospectus needs only to contain information if a “person whose knowledge is relevant” actually knows the information or in the circumstances ought reasonably to have obtained the information by making inquiries. For this purpose, a person's knowledge is relevant if they are the person offering the securities, a director or proposed director of the body offering the securities, a person named in the prospectus as an underwriter of the issue or sale of the securities, a person named in the prospectus as a financial services licensee involved in the issue or sale of the securities, a person named in the prospectus with their consent as having made a statement that is included in the prospectus or on which a statement in the prospectus is based and a person named in the prospectus with their consent as having performed a particular professional or advisory function.

Section 711 of the *Corporations Act* requires a prospectus to also contain certain specific information, including:

- the terms and conditions of the offer;
- the details of the interests and fees of certain people involved in the offer;

- if the securities are to be traded on a financial market, details of this; and
- an expiry date, being a date no later than 13 months after the date of the prospectus.

Sections 712 and 713 also contain special rules for prospectuses in certain situations (where shortform prospectuses are to be used or where the securities are continuously quoted).

Sections 714 and 715 set out the disclosure obligations in relation to, respectively, profile statements and offer information statements.

3.2.3 Breach of the statutory disclosure obligations

Section 728

Section 728(1) of the *Corporations Act* provides that a person must not offer securities under a disclosure document if there is:

“(a) a misleading or deceptive statement in:

- (i) the disclosure document; or*
- (ii) any application form that accompanies the disclosure document; or*
- (iii) any document that contains the offer if the offer is not in the disclosure document or the application form; or*

(b) an omission from the disclosure document of material required by section 710, 711, 712, 713, 714 or 715; or

(c) a new circumstance that:

- (i) has arisen since the disclosure document was lodged; and*
- (ii) would have been required by section 710, 711, 712, 713, 714 or 715 to be included in the disclosure document if it had arisen before the disclosure document was lodged.”*

Criminal consequences

A person commits an offence if they contravene section 728(1) and the misleading or deceptive statement or the omission or new circumstance is materially adverse from the point of view of an investor (section 728(3)). Such an offence carries a maximum penalty of 200 penalty units, imprisonment for five years or both (section 1311 and Schedule 3).

Civil consequences

In addition, section 729(1) provides that a person who suffers loss or damage because an offer of securities under a disclosure document contravenes subsection 728(1) may recover the amount of the loss or damage from certain persons or classes of person.

They include the person making the offer, each director or person named in the disclosure document with their consent as a proposed director of the body making the offer, an underwriter (but not a sub underwriter) named in the disclosure document with their consent, a person named in the disclosure document with their consent in relation to a statement included in the disclosure statement or which a statement made in the disclosure document is based (but only if the contravention related to the statement) and any other person involved “*in the contravention*” of section 728(1) (see section 3.3.6 for the meaning of the phrase involved “*in the contravention*”).

Defences

Section 731 provides that a person does not commit a criminal offence, and is not civilly liable under section 729, for a contravention of section 728(1) because of a misleading or deceptive statement in a prospectus, or an omission from a prospectus in relation to a matter, if the person proves that they:

- made all inquiries (if any) that were reasonable in the circumstances; and
- after doing so, believed on reasonable grounds that the statement was not misleading or deceptive or that there was no omission from the prospectus in relation to the relevant matter.

This is known as the “due diligence defence”.

There are also other defences in sections 732 and 733.

3.2.4 The application of the positive disclosure obligations to securitisation

In most cases, sections 728 and 729 have no direct application to information memorandums used by the securitisation industry. The reason is that the sections do not apply where the offer of securities does not need disclosure to investors under section 708. This, though, does not mean that sections 728 and 729 can be completely ignored. They continue to have indirect relevance in determining whether an omission from an information memorandum can lead to civil liability, which is the subject of the next section.

3.3 Civil liability for a defective information memorandum

3.3.1 Legislative overview

In Australia, civil liability is imposed in relation to an information memorandum used in relation to a securitisation where it is “*misleading or deceptive*” or “*is likely to mislead or deceive*”.

The statutory source for this stems from (depending on the circumstances) section 1041H of the *Corporations Act*, section 12DA(1) of the ASIC Act or, if these previous provisions do not apply, section 52 of the TPA.

Section 1041H provides:

“A person must not, in this jurisdiction, engage in conduct in relation to a financial product or a financial service, that is misleading or deceptive or is likely to mislead or deceive.”

Section 12DA(1) of the ASIC Act provides:

“A person must not, in trade or commerce, engage in conduct in relation to financial services that is misleading or deceptive or is likely to mislead or deceive.”

Whilst the sections substantially overlap and proscribe the same conduct, there are some important differences, including:

- section 1041H applies to conduct “in this jurisdiction”, whilst section 12DA(1) has extra-territorial application;
- standing is required to bring an injunction in relation to a breach of section 1041H whilst this is not required in relation to a breach of section 12DA(1); and
- while a breach of both sections give rise to civil liabilities, the regimes for this are different for each.

Section 1041H and section 12DA(1) are borrowed from section 52 of the TPA. The approach taken by most commentators when analysing section 995(2) (the predecessor to section 1041H) was to conclude that by adopting the language of section 52 of the TPA, the legislature intended to import the interpretation that the courts have placed on section 52. This approach is supported by *Fraser v NRMA Holdings Limited* (1995) 13 ACLC 132, a case brought under section 52, but where the court stated that had the applicants sought to rely on section 995(2), the issues for determination would have been substantially the same. Such an approach is likely to also apply in relation to sections 1041H and 12DA(1).

3.3.2 Misleading or deceptive conduct

The touchstone for liability for a breach of sections 1041H and 12DA(1) is that the effect of the misstatement in, or omission from, the information memorandum must be misleading or deceptive. The meaning attributed to these words is to “lead into error”. A court will take a practical and realistic view of the effect of the relevant conduct. Evidence that a particular person has been misled, whilst persuasive, is neither conclusive nor essential, as a court will determine the question for itself.

While the test is objective, the likely effect of the relevant conduct is not assessed in isolation. Instead, the court identifies the relevant section of the public exposed to the conduct in question and attributes to the audience a standard of sophistication against which the court decides whether the conduct was misleading or deceptive or was likely to mislead or deceive. The audience may be as wide as the public at large or may be confined to a segment of it, such as the investing public.

It is likely that a court will attribute a relatively high level of sophistication to investors in the wholesale capital markets. As a result, unlike where the recipients are ordinary members of the public or are relatively unsophisticated, a court will probably be less willing to construe half truths and ambiguities in an information memorandum as constituting misleading or deceptive conduct.

3.3.3 Omissions from an information memorandum

Traditionally, the greatest concern of those involved in the preparation of an information memorandum is that despite the precautions that may be taken to ensure that all relevant information is disclosed, an omission may nevertheless occur which could be regarded by a court as constituting misleading or deceptive conduct.

The extent to which silence can amount to misleading or deceptive conduct has been, and continues to be, one of the more contentious areas of the case law in relation to section 52 (and hence, also, sections 1041H and 12DA(1)).

The current approach of the courts is to assess whether the circumstances are such as to give rise to a “reasonable expectation” of full disclosure. In determining this, the courts take into account factors such as the relationship between the parties, their knowledge and expertise, previous communications and any other relevant factors.

Where there is a “reasonable expectation” that certain material will be disclosed, the failure to do so is misleading or deceptive as it implies that the material does not exist.

The test of whether an omission from an information memorandum constitutes a breach of sections 1041H and 12DA(1) depends, therefore, upon whether an investor had a “reasonable expectation” that the omitted material would be disclosed. Although the sections do not create an independent duty of disclosure, in practice they have this result through the “reasonable expectation” test. If the test is not satisfied, then those responsible are exposed to potential liability for a breach of these sections. It is therefore important for those involved in the preparation of an information memorandum to be able to

assess precisely the type of material that a court is likely to consider should be disclosed in a capital markets information memorandum.

To date there has been no case law directly on this issue. The answer is likely to turn on a court's assessment of the function and role of an information memorandum in the investment process. Unfortunately, there appear to be two opposite views on this.

The first is that investors typically do not have access, nor are privy, to all information relating to the particular capital markets securities. An information memorandum, therefore, performs a function similar to that of a prospectus by providing an intending investor with all material information necessary to make an investment decision. Accordingly, the material that an investor would expect to be disclosed in an information memorandum is similar to the standard set out in section 710 of the *Corporations Act*, ie. all information that investors and their professional advisers would reasonably require to make an informed assessment of the issuer and the relevant securities.

The contrary view is that those who prepare an information memorandum are not investors. They cannot predict all the information that would be relevant to an investment decision. While all due care may be taken to prepare an information memorandum, there is no guarantee that it contains all relevant information. It is the duty of each prospective investor to satisfy themselves on this front. If a prospective investor fails to adequately protect its interests, this should not lead to liability for those who prepare an information memorandum.

There is some merit in both views. On one hand, investors are largely dependent on the disclosures in an information memorandum in making their investment decisions. On the other hand, to require disclosures equivalent to a section 710 standard would be to equate capital markets investors to members of the public; yet the present legislative scheme is founded on the assumption that sophisticated investors do not need the protection of prospectus legislation.

The doubt regarding the appropriate standard of disclosure in an information memorandum represents a major deficiency with the present situation. It creates a substantial uncertainty for those involved in the preparation of an information memorandum regarding the disclosures necessary to avoid liability for a breach of sections 1041H and 12DA(1).

3.3.4 Inadvertent omissions

Another area of uncertainty in relation to omissions is whether an *inadvertent* (as opposed to a deliberate) failure to disclose material in an information memorandum can breach sections 1041H and 12DA(1).

The expression "engaging in conduct" is defined in section 12BA(2) of the ASIC Act as, amongst other things, "doing or refusing to do any act". The phrase "refusing to do an act" is defined to include "restraining (otherwise than inadvertently) from doing that act". These definitions are identical to those in section 4(2) of the TPA.

The expression "engage in conduct" is defined in section 9(1) of the *Corporations Act* as "to do an act or thing or to omit to perform an act or thing" (see also the definition of act in section 9(1)). Importantly, unlike the corresponding definitions of engaging in conduct under the ASIC Act and the TPA, the *Corporations Act* definition does not specifically exclude inadvertent omissions.

The exception in section 12BA(2) of the ASIC Act suggests that conduct does not include an inadvertent failure to do an act and that a positive refusal to do an act is required before it can be said that there has been "conduct". This line of reasoning suggests that an innocent omission from an information memorandum will not lead to a breach of section 12DA. However, this approach is in tension with the well established principle that knowledge is not a necessary ingredient for a breach of section 52 (and presumably sections 12DA(1) and 1041H). In *Parkdale Custom Built Furniture Pty Limited v Puxu Pty Limited* (1982) 149 CLR 191, Chief Justice Gibbs stated:

"There is nothing in the section that would confine it to conduct which was engaged in as a result of a failure to take reasonable care. A corporation which has acted honestly and reasonably may therefore nevertheless be rendered liable to be restrained by injunction and to pay damages if its conduct has in fact misled or deceived or is likely to mislead or deceive."

This approach was endorsed by the Full Federal Court in *Fraser v NRMA Holdings*:

"... for the purposes of section 52, if by reason of what was said and what was left unsaid the conduct of the corporation is misleading or deceptive or likely to mislead or deceive, a contravention would occur even if the corporation through its directors and officers did not have knowledge of the undisclosed facts which rendered the conduct in breach of section 52."

The implication of this approach in relation to a breach of section 52, and lack of any specific exemption for inadvertent failures under section 1041H, is that if the “*reasonable expectation*” test carries with it a standard of disclosure, as seems likely, and an issuer innocently fails to meet that standard, even after say due diligence, then a breach of sections 1041H and 12DA(1) could occur. This imposes a very exacting (if not unfair) requirement on issuers and is to be compared to the more favourable treatment in relation to a misleading or deceptive statement in a disclosure document where a liability for a breach of section 728 can be met by the due diligence defence of section 731.

An alternative approach is for the courts to incorporate within the “*reasonable expectation*” test a standard of diligence in relation to an information memorandum. For example, they may consider that capital markets investors would reasonably expect an information memorandum to only state material known to the issuer or that the information memorandum would only be issued after due diligence by those responsible for its preparation. This would deal with the problem of the potential liability that an issuer has for omissions not known to it, and would also be consistent with the likely expectation of capital markets investors. However, until the issue is considered by the courts, those responsible for the preparation of an information memorandum face the prospect of potential liability for failing to disclose information which is not known to them.

3.3.5 The consequences of a contravention

A breach of sections 1041H and 12DA does not constitute an offence (sections 1311 of the *Corporations Act* and 12GB(1) of the ASIC Act, respectively). However, a person who suffers loss or damage by conduct in breach of section 1041H or 12DA may recover the amount of this under sections 1041I of the *Corporations Act* and 12GF of the ASIC Act, respectively.

3.3.6 Two classes of persons exposed to civil liability

Sections 1041I of the *Corporations Act* and 12GF of the ASIC Act impose civil liability on the person who “*engaged*” in the conduct constituting the contravention and on any other person “*involved in the contravention*”.

Engaged in a contravention

Normally, an information memorandum identifies the party that takes responsibility for its contents. It is this person who engages in the relevant conduct for the purposes of sections 1041H and 12DA. Usually, this is the issuer of the relevant securities or the manager or sponsor of the program. Sometimes, where a number of parties have prepared an information memorandum, they take

responsibility for their individual portions. A single information memorandum in these circumstances can, therefore, comprise a series of separate instances of conduct by different parties.

Section 52 of the *Corporations Act* provides that a reference to doing an act includes a “reference to causing or authorising the act ... to be done”. Section 52 applies to both section 12GF (section 5(3) of the ASIC Act) and to section 1041I. As a result, the directors who formally authorise the issue of a defective information memorandum are probably deemed to engage in a contravention of the sections.

Involved in a contravention

Section 79 of the *Corporations Act* defines the phrase “involved in a contravention” as follows:

“A person is involved in a contravention if, and only if, the person:

- (a) has aided, abetted, counselled or procured the contravention;
- (b) has induced, whether by threats or promises or otherwise, the contravention;
- (c) has been in any way, by act or omission, directly or indirectly, knowingly concerned in, or party to, the contravention; or
- (d) has conspired with others to effect the contravention.”

Section 79 also applies to section 12GF (see section 5(2) of the ASIC Act).

3.3.7 The position of dealers

Securitized instruments are usually issued through a dealer panel. The name of each dealer often appears on the front page and in the body of the information memorandum as performing this role. The dealers also distribute the information memorandum to potential investors, sometimes accompanied by supplementary materials prepared by them regarding the securities on offer.

Normally, an information memorandum will include a disclaimer that the dealers have not prepared, and do not accept liability, for its contents (except, perhaps, in relation to nominated sections prepared by a particular dealer).

A dealer, though, can be exposed to potential liability on a defective information memorandum in a variety of ways. It will, for example, be liable for those sections in respect of which it has specifically accepted responsibility. In addition, depending on the extent to which it has assisted in the preparation of the information memorandum, it may be liable on the basis that it has caused the issue for the purposes of section 52 of the

Corporations Act or that it was *involved* in the contravention for the purposes of section 79 of the *Corporations Act* (see above).

Another area of risk for dealers is that by innocently distributing a defective information memorandum, notwithstanding the disclaimer referred to above, they will incur liability for a contravention of sections 1041H and 12DA.

The difficulty for dealers in this area is highlighted by the decision in *John G Glass Real Estate Pty. Limited v Karawi Constructions Pty. Limited* [1993] ATPR 41–249. There, a real estate agent, acting for the vendor in the sale of an office building, passed on an incorrect figure for the net lettable area of the building. The figure was included in a brochure indicating that the source was a consultant acting for the vendor. The front page of the brochure contained the name of the real estate agent. The brochure also contained a disclaimer stating, amongst other things, that the information in the brochure had been prepared with care by the real estate agent or had been supplied to it by apparently reliable sources and that the real estate agent had no reason to doubt its completeness or accuracy. The disclaimer went on to state that the real estate agent did not guarantee the information and that all interested parties should make their own inquiries to verify the information and that it was the responsibility of interested parties to satisfy themselves in all respects regarding the property.

The Full Federal Court held that the real estate agent was liable under section 52 of the TPA for damages to the purchaser for the incorrect figure. The court stated:

"In our opinion an estate agent which holds itself out as, amongst other things, consultants to institutional investors and to developers of major properties would not be regarded by potential purchasers of properties as merely passing on information about the property "for what it is worth and without any belief in its truth or falsity ... In the present case the [real estate agent] adopted the information in question and incorporated it as an essential and prominent feature of their selling effort on behalf of the vendor. There was certainly no expressed disclaimer of the [real estate agent's] belief in the truth of the information in the brochure – indeed there was an express assertion of such belief. As part of its ordinary business the agent was providing the information in a persuasive form with a view to achieving a sale of its principal's property and of course earning commission. It was this conduct which the learned trial judge, correctly in our opinion, held to be misleading and deceptive. Once the falsity of the figure was demonstrated, it seems to us that no other conclusion could follow."

In December 2004, the High Court of Australia handed down its judgment in *Butcher v Lachlan Elder Realty Pty Ltd* [2004] HCA 260, in which it considered some of the issues raised in *John G Glass Real Estate*. In *Butcher*, the appellants had purchased a valuable waterfront property in Sydney and the respondent was the real estate agent that had acted for the vendor in that sale.

The appellant had sued the real estate agent because, it claimed (among other things), a brochure issued by the real estate agent in connection with the property was misleading because it misrepresented the location of one of the boundaries to the property.

In denying the appellants' claim, the majority of the High Court found that:

"...it would have been plain to a reasonable purchaser that the agent was not the source of the information which was said to be misleading. The agent did not purport to do anything more than pass on information supplied by another or others. It both expressly and implicitly disclaimed any belief in the truth or falsity of that information. It did no more than state a belief in the reliability of the sources."

The majority then distinguished these circumstances from the circumstances in the *John G Glass Real Estate* case on two grounds. First, as noted above, the estate agent in *John G Glass Real Estate* would not have been regarded as merely passing on information to potential purchasers of property. Secondly, in *John G Glass Real Estate*, the net lettable area figure was one of hard physical fact and essential to determining the profitability and value of the building, whereas in *Butcher* the correspondence between the property boundary and the survey diagram in the real estate agent's brochure was not a matter of hard physical fact (although this seems to be a tenuous distinction). Further, in *John G Glass Real Estate* there was nothing to indicate that the net lettable area figure had not been calculated by John G Glass Real Estate itself, whereas in *Butcher* the real estate agent had obviously not prepared the survey diagram in the brochure. The majority summarised this by endorsing the Court of Appeals statement in its decision in respect of *Butcher* that in *John G Glass Real Estate*:

"...the agents claimed relevant expertise, adopted the figures as their own, and put them forward without any reference to their source. In [Butcher], the agents claimed no relevant expertise, and the diagram itself indicated that it was the work of a professional surveyor."

Interestingly, the majority then went on to question the conclusion in the *John G Glass Real Estate* case that, as noted above, the agent expressly asserted the truth of the information in the brochure: "It does not seem quite correct to describe an estate agent which says it has no reason to doubt the accuracy of information but says it does not guarantee it, advises interested parties to make their own inquiries, and says interested parties have the responsibility of satisfying themselves in all respects, as making an "express assertion" of belief in the information." It is possible to infer from this that the majority of the High Court may not have reached the same decision in *John G Glass Real Estate* as the Full Federal Court.

The majority were of the view that if an agent presents information provided to it by its principal, whether the agent is making a representation about the truth of such information will depend upon the circumstances in the particular context:

"There could be cases where the presentation by an agent of a principal's document to a plaintiff does not involve the agent in making a representation about the objective truth of the document's contents; and there could be cases where the incorporation of a principal's document into another document prepared by an agent will not involve the agent in making a representation about any matter of objective truth, whether the principal's document is considered by itself or in conjunction with other material in the agent's document."

Further, the majority noted that the relevant authorities do not say that disclaimers cannot make clear who is and who is not the author of misleading and deceptive conduct.

On a related point, the majority of the High Court in *Butcher* considered what level of examination of the language and structure of the brochure is appropriate in considering whether the agent had made a representation in the brochure. The High Court was of the view that a close, detailed examination of the brochure was appropriate, since the purchasers had 12 days to review the document prior to the relevant auction and had instructed professional advisers in connection with the transaction.

Butcher is also noteworthy for the strongly reasoned dissenting judgments of Justices McHugh and Kirby. Justice McHugh noted that for the purposes of interpreting section 52 "conduct" (which is broadly defined, as noted above), is not confined to representations - section 52 may operate whether or not the relevant conduct constitutes a representation. What is required is merely that conduct is engaged in, and that the conduct is misleading or deceptive (or likely to mislead or deceive) which is

a broader concept than a misleading representation. Accordingly, rather than considering whether the estate agent had made a misleading representation to the purchaser, Justice McHugh in his decision to allow the appeal considered whether conduct had been engaged in (distributing the brochure) and whether that conduct had been misleading or deceptive (misrepresenting the location of one of the property boundaries). Publishing erroneous information received from others may be misleading or deceptive conduct, depending upon whether the relevant company has assumed responsibility for that information (or endorsed or used its name in associations with it) so that it would be reasonable for a recipient to rely on the information, and whether the relevant company has disclaimed any belief in the truth or falsity of the information or disclaimed any personal responsibility for it. The decision in *Butcher* makes it clear that in order to avoid potential liability in respect of an information memorandum, dealers need to continue to insist that the information memorandum make it clear that the dealers are not the author of that document (other than any information in respect of themselves) - that is, that they are merely passing on the information contained in the information memorandum to potential investors, and that they do not accept any responsibility as to its accuracy or completeness. Although, as discussed below, a disclaimer cannot remove liability for misleading and deceptive conduct, judicial authority supports the position of dealers being able to avoid liability for an information memorandum by making it clear who is responsible for the relevant information.

Another area of risk for dealers is that by merely being associated with the issue of the relevant securities, an erroneous implication may be drawn by investors regarding the veracity of the material contained in the information memorandum. An example of this is the Dutch decision of *Association of Bondholders Coopag Finance BV v ABN AMRO Bank NV*. There, ABN AMRO, who was the lead manager in a euro-bond issue, was held liable under the Dutch Civil Code (which is analogous in its relevant terms to section 1041H) in relation to a defective information memorandum. This was on the basis that its participation implied that it had engaged in due diligence of certain materials contained in the information memorandum, when in fact it had not undertaken this.

3.3.8 Disclaimers

Their use in an information memorandum

An information memorandum almost always contains a detailed disclaimer of liability. This is usually found in the Important Notice section at the front of the information memorandum.

Disclaimers vary in their language, but usually fall into one of two classes:

- often, but not always, the information memorandum contains an express denial of liability in respect of representations or statements contained in it.
- usually investors will be directed to make and rely upon their own inquiries in relation to the securities on offer.

Disclaimers as a means of avoiding a contravention

It is clear that a disclaimer cannot oust section 52 of the TPA (and presumably sections 1041H of the *Corporations Act* and 12DA of the ASIC Act). Where a person engages in misleading or deceptive conduct through a defective information memorandum, a disclaimer as in the first disclaimer above, will be ineffective.

Using disclaimers to eliminate reliance

Sections 1041I of the *Corporations Act* and 12GF of the ASIC Act each require that a plaintiff establish a causal connection between the misleading and deceptive conduct and the loss claimed (“loss or damage by conduct of another person”).

The second class of disclaimer referred to above seeks to eliminate the causal connection between the misleading or deceptive conduct and the alleged damage, by advising intending investors that they must not rely on the information memorandum.

Although there are some authorities in support of the second class of disclaimer, a consistent and uniform judicial approach has yet to emerge on this issue. It is likely that the courts would be more prepared to uphold such a disclaimer where the recipient, as with a capital markets issue, is sophisticated. However, it is equally likely that a court’s approach will also be influenced by its assessment of how practical it would have been for an investor to rely on its own inquiries. If the court takes the view that an investor could not have reasonably implemented the direction in the disclaimer, then it probably will not give effect to its terms.

3.4 Conclusion

The *Corporations Act* and the ASIC Act (and other similar legislation) impose substantial civil consequences on those responsible for the preparation of a defective information memorandum. Securitiser need to be particularly mindful of these and to institute procedures for the preparation of an information memorandum in a systematic manner to ensure its completeness and accuracy. It is only by these means that the risks for securitisers from defective information memorandums will be minimised.

The next two sections of this publication deal with some of the revenue impacts on securitisation. These are stamp duty (section 4) and tax (section 5).

4 Stamp duty and securitisation

4.1 Introduction

There is a potential for stamp duty to be levied on several stages of a typical securitisation. These include the declarations of trust (for trust securitisations) and the security trust, the transfer of assets into the securitisation vehicle, the grant of a charge over the assets of the securitisation vehicle in favour of the security trustee and the issue and transfer of the securitised instruments. Most securitisations would not be economically feasible if ad valorem duty was imposed at any of these points. Accordingly, it is important to structure securitisations so that they do not attract duty at any stage of the process. This task is made more complex as stamp duty is a State-based tax and the relevant legislation differs from jurisdiction to jurisdiction.

Time and space do not permit a detailed analysis of the stamp duty position as it applies throughout Australia.

Given the central importance of the New South Wales *Duties Act*, this section will concentrate on the New South Wales stamp duty position under that Act. One or two comments will, though, be made on the position in other States and Territories.

4.2 Duties Act General overview

The underlying intention in drafting the *Duties Act* was to rewrite the *Stamp Duties Act 1920* (the 1920 Act) in a simpler, more contemporary style and to facilitate harmonisation with the other jurisdictions participating in the project.

Various policy changes were also made. They included the following which are relevant to securitisation:

- “debentures” are no longer dutiable as loan securities. Loan securities are only dutiable if they are mortgages or charges over property and the property is located, or deemed to be located, in New South Wales.
- the conveyance head of duty, which applied to any property in New South Wales, was replaced with a regime levying the same rates of duty in respect of any “transfer of dutiable property”.

A “transfer” is effectively defined in section 8 of the *Duties Act* to include “an agreement for sale, an agreement for transfer, a declaration of trust or any one of certain limited classes of transaction affecting dutiable property”.

“Dutiable property” in turn is defined in section 11 to include the following:

- *land, transferable floor space or a land use entitlement;*
- *shares not quoted on the stock exchange;*

- *units in a unit trust scheme;*
- *good will, intellectual property and Commonwealth statutory licences exploited within the 12 month period prior to the transaction;*
- *New South Wales statutory licences or permissions;*
- *partnership interests;*
- *goods, if those goods are subject to a dutiable transaction along with any other dutiable property, other than intellectual property; there is a carve out for stock in trade;*
- *an option to purchase land;*
- *an interest in any dutiable property except to the extent that:*
 - *it arises as a consequence of the ownership of a unit in a unit trust scheme and is not a land use entitlement; or*
 - *it is attributable to an option over dutiable property.*

Significantly, most financial assets are not dutiable property and so fall outside the reach of the transfer head of duty. (In this regard, section 65(1)(d) retains an express exemption for transfers of mortgages or declarations of trust over mortgages of dutiable property.)

If a transfer of dutiable property occurs, it does not matter whether or not that transfer is effected by a written instrument. If it is not effected by a written instrument, a statement must be lodged and duty must be paid on that statement.

4.3 Creation of a securitisation trust

The majority of securitised structures involve the creation of a trust.

Declarations of trust, whether or not they are in writing, attract ad valorem transfer duty of up to 5.5 percent of the value of the dutiable property the subject of the trust. For the reasons referred to in section 4.2, this duty will have little impact on securitisations as, generally speaking, the assets which are the subject of the trust are not dutiable property.

Nominal duty may still be payable on a declaration of trust for a securitisation. If a declaration of trust is made in writing and signed in New South Wales it will attract duty of \$200 provided it declares a trust over property which is not dutiable property (see section 58(1)). Duty of \$200 is also payable where no property is identified in the trust instrument, but the instrument is executed in New South Wales (see section 58(2)).

4.4 Transfers of mortgages and other assets

Most securitisations involve a transfer of property from an originator to a special purpose vehicle. Depending on the nature of the property to be transferred and the stamp duty legislation applicable to that transfer, ad valorem transfer or conveyance duty may be payable in respect of the transfer.

In New South Wales, under the *Duties Act*, transfers of mortgages, debts and other choses in action are not dutiable due to the relatively narrow dutiable property definition in section 11 and the exemption for mortgagees' interests in dutiable property in section 65(1)(d) (see above).

In undertaking the stamp duty structuring of a securitisation, it is important to assess whether the New South Wales *Duties Act* is the only applicable stamp duties legislation.

If it is, traditional drafting techniques involving the use of a *Claytons contract* for the transfer of financial assets may not be required. If however, the transfer transaction is one which would have a territorial connection to Western Australia or South Australia, such techniques would still be appropriate.

4.5 Charge over property

Most structures involve a charge over the securitised assets as security for the issuer's obligations under the debt instruments issued to investors. The charge may be liable for mortgage duty in New South Wales under Chapter 7 of the *Duties Act*. All the other States have a similar head of duty.

The duty payable is approximately 0.4 percent of the amount secured (ie. on the face value of debt instruments outstanding), which can constitute a substantial cost to be borne by an issuer. It is not uncommon for issuers to seek to take advantage of the absence of mortgage or loan security duty in the Australian Capital Territory and to execute the security in that jurisdiction or in any other jurisdiction other than South Australia or Western Australia at a time when its only secured assets are located in the Australian Capital Territory. This then raises the issue of whether there are any applicable clawback provisions which catch the security at a date following execution. The answer to this depends on the legislation of the relevant jurisdictions in which the subsequently charged property is located.

Section 208(3) of the NSW *Duties Act* contains an after acquired land provision which levies duty on securities over land acquired within 12 months of execution of the security. Similar provisions appear in the *Duties Acts* of Tasmania, Queensland and Western Australia.

Extra care needs to be exercised in relation to the Queensland and Western Australia provisions because of their other limb, which catches securities for after-acquired property which is specifically identified, whether or not in the instrument, at the time the instrument is first signed.

All these comments regarding mortgage duty represent the position which applies were it not for the relief offered for mortgage backed (and certain other) securitisations under the *Duties Acts* in New South Wales, Tasmania and Queensland. No such relief is available in South Australia or Western Australia. Naturally, the abolition of mortgage duty in Victoria has also provided relief.

4.6 Issue of securities to investors

Under the 1920 Act there was a concern that the land rich provisions in Division 30 could apply to the issue of equity mortgage-backed securities, since mortgages at law involve interests in land. Under the *Duties Act*, however, section 163C(1) excludes the estate or interest of a mortgagee or chargee when identifying an entity's land holdings so that there is no possibility of the land rich provisions in chapter 4A applying to equity mortgage-backed securities.

As debenture duty has been abolished, the creation or issue of debentures and other debt securities does not attract duty.

4.7 Transfer of securities between investors and the secondary market

The transfer of a unit in a private unit trust is subject to marketable securities duty of 0.6 percent if the register is kept in New South Wales or, if there is no register in Australia, the manager (or if there is no manager, the trustee) of the trust is incorporated or resident in New South Wales. A transfer of a unit on a New South Wales register can also attract a liability in other States. Accordingly, the law of other States needs to be considered.

As discussed previously, debt securities are not dutiable property and so they can be transferred without liability for New South Wales duty.

4.8 Relief for mortgage-backed securities in New South Wales

Some time ago, New South Wales attempted to sponsor the growth of the mortgage-backed securities market by removing stamp duty on the issue and transfer of qualifying “mortgage-backed securities” and on the underlying transactions required to create such securities. The exemptions were repeated in a slightly different form in the *Duties Act*.

Under section 282(3) there is no duty chargeable under the *Duties Act* in respect of:

- “(a) the issue or making of a mortgage-backed security, or*
- (b) the transfer or assignment, of or other dealing with a mortgage-backed security, or*
- (c) the discharge, cancellation or termination of a mortgage-backed security.”*

Given the *Duties Act*’s relatively narrow tax base, many of these transactions would not have attracted duty anyway. The transfer of equity securities is perhaps the only exception.

Relief from duty is also given in respect of:

- a charge over a collateralised mortgage pool securing the issuer’s obligations for mortgage-backed debt securities (section 282(1));
- a charge over a collateralised mortgage pool which is given *in connection with* creating, issuing, marketing or securing a mortgage-backed security (section 282(2));
- a charge over a collateralised mortgage pool given *for the purpose* of creating, issuing, marketing or securing a mortgage-backed security to or by certain persons (section 282(4)); and
- any instrument that in the opinion of the Chief Commissioner was executed for the purpose of creating, issuing or marketing mortgage-backed securities (section 283).

The concessions relate only to a mortgage-backed security. This term is defined in the *Duties Act*:

“(a) an interest in a trust that entitles the holder of or beneficial owner under the interest:

- (i) to the whole or any part of the rights or entitlements of a mortgagee and any other rights or entitlements in respect of a mortgage or any money payable by the mortgagor under the mortgage (whether the money is payable to the holder of or beneficial owner under the interest on the same terms and conditions as under the mortgage or not), or*

- (ii) to the whole or any part of the rights or entitlements of a mortgagee and any other rights or entitlements in respect of a pool of mortgages or any money payable by mortgagors under those mortgages (whether the money is payable to the holder of or beneficial owner under the interest on the same terms and conditions as under the mortgages or not), or*

- (iii) to payments that are derived substantially or, if the regulations prescribe the extent, to the prescribed extent, from the income or receipts of a pool of mortgages, and that may, in addition, entitle the holder or beneficial owner to a transfer or assignment of the mortgage or mortgages, or*

- (b) a debt security (whether or not in writing) the payments under which by the person who issues or makes the debt security are derived substantially or, if the regulations prescribe the extent, to the prescribed extent, from the income or receipts of a pool of mortgages, or*

- (c) any of the following:*

- (i) an interest in a trust creating, conferring or comprising a right or interest (whether described as a unit, bond or otherwise) of or on a beneficiary in a scheme under which any profit or income in which the beneficiaries participate arises from the acquisition, holding, management or disposal of prescribed property, or any instrument that evidences such a right or interest;*

- (ii) a security (whether or not in writing) the payments under which by the person who issues or makes the security are derived substantially from the income or receipts of prescribed property;*

- (iii) an interest in a trust, a debt security (whether or not in writing), an instrument or property that creates an interest in or charge over an interest in a trust, a debt security (whether or not in writing) or other instrument or property, to which paragraph (a) or (b) or subparagraph (i) or (ii) of this paragraph applies, but does not include an instrument or property comprising; or*

- (d) a mortgage; or*

- (e) the transfer of a mortgage; or*

- (f) a declaration of trust; or*

- (g) an instrument of a class or description of instruments, or property of a class or description of property, prescribed not to be a mortgage-backed security for the purposes of this definition.”*

Note that paragraphs (a)(iii) and (b) are equivalents – one relates to equity interests and the other to debt securities (whether or not in writing). In practical terms, they both require a dedication of the relevant income stream to meet the obligations under the interests or securities, so that the derivation test is satisfied, but permit an insubstantial amount of other income (ie. from any source) to flow to investors. (Contrast them to paragraphs (a)(i) and (ii) where the derivation of the relevant income stream is not mentioned, presumably because the focus is on a pass-through arrangement).

The concept of a “pool of mortgages” is central to both as it determines the source of the substantial income stream. It is defined as:

“A pool or collection of assets:

- (a) that is comprised solely of mortgages, or
- (b) that is comprised substantially or, if the regulations prescribe the extent, to the prescribed extent, of mortgages or of money paid pursuant to mortgages (whether or not that money has been invested in prescribed property) or of money (whether or not that money has been invested in prescribed property) if the primary investment policy is to invest in mortgages, but that may also contain either or both of the following:
 - (i) prescribed property,
 - (ii) any other property that forms part of the pool or collection of assets for the purpose of issuing or making a mortgage-backed security in relation to the pool of mortgages.”

“Mortgages” includes mortgages of all kinds of land (wherever located), both residential and non-residential, freehold and leasehold.

Thus it remains the case under the *Duties Act* that the concessions in sections 282 and 283 are principally aimed at sponsoring the securitisation of mortgages. Prima facie, asset-backed securities, such as those relating to credit card and lease receivables, are not entitled to the benefit of the mortgage-backed security concessions and duty may be payable on several stages of their securitisation process. How much duty is payable (if any) will, of course, depend on the structure adopted.

It is significant that the term “prescribed property” is used both in the “pool of mortgages” definition and in the “mortgage-backed security” definition itself (see paragraph (c)). The use in paragraph (c) of the definition of “mortgage-backed security” has the effect of broadening the definition beyond its natural meaning. An instrument will still qualify as a mortgage backed

security even though there are no supporting mortgages, provided the underlying pool is comprised of other “prescribed property”. In the case of paragraph (c)(ii), the income must be derived substantially from prescribed property, so that an insubstantial part of the income can be derived from other sources. (Contrast paragraph (c)(i) which lacks this flexibility in relation to the source of income.)

“Prescribed property” means *any of the following*:

- “(a) cash,
- (b) bonds, debentures, stock or Treasury Bills of the Commonwealth or the Government of New South Wales or the Government or Administration of another State or Territory,
- (c) debentures or stock of any public statutory body constituted under the law of the Commonwealth or New South Wales or another State or Territory,
- (d) notes or other securities of the Commonwealth or the Government of New South Wales or the Government or Administration of another State or Territory,
- (e) deposits with, or the acquisition of certificates of deposits or any other security issued by, a bank or building society (whether expressed in Australian currency or otherwise),
- (f) bills of exchange, promissory notes or other negotiable instruments accepted, drawn or endorsed by a bank (whether expressed in Australian currency or otherwise),
- (g) a guaranteed investment contract (expressed in Australian currency) of a type approved by the Chief Commissioner,
- (h) mortgage-backed securities, mortgage backed certificates within the meaning of Part 1B of the *Trustee Act 1958 of Victoria* or marketable securities that are secondary mortgage market securities under section 29(1) of the *Mortgages (Secondary Market) Act 1984 of Queensland*.”

4.9 Relief in other States

There are equivalent, although not identical, mortgage-backed security exemptions in Queensland, Victoria and Tasmania.

Queensland has introduced asset backed securitisation relief, back-dated to 1 March 2002 (see the *Revenue Legislation Amendment Act 2002*). Perhaps the best feature of this relief is that it overcomes transfer duty on a defined class of “financial assets”.

4.10 Conclusion

Stamp duty is a very complicated and legalistic area. This section highlights some of the principles that are relevant to the securitisation industry. Because of its importance, stamp duty has and will continue, for the foreseeable future, to play a critically important role in the structuring of securitisation programs in Australia.

The next section of this publication examines some of the taxation issues relevant to securitisations in Australia.

5 Taxation issues relevant to securitisation

5.1 Introduction

This section deals principally with four issues:

- section 5.2 describes the general principles of Commonwealth income taxation and their application to securitisation programs;
- section 5.3 analyses the interest withholding tax rules and the requirements that need to be complied with where an Australian securitisation program seeks to issue securities to foreign investors;
- section 5.8 describes the GST regime and highlights some of the major areas for concern to securitisation programs; and
- section 5.9 provides a summary of changes to the Australian tax regime which have been foreshadowed as at the date of this publication.

5.2 Income tax issues for securitisation programs

5.2.1 Overview

Income tax in Australia is currently levied under two Acts – the *Income Tax Assessment Act 1936* (the 1936 Tax Act) and the *Income Tax Assessment Act 1997* (the 1997 Tax Act). The 1997 Tax Act is being progressively enacted and is essentially a rewrite of the 1936 Tax Act. The intention is that the provisions of the 1997 Tax Act express the same law as in the 1936 Tax Act but in a clearer style.

One of the key concerns during the structuring phase of a securitisation program is to ensure the tax neutrality of the securitisation vehicle (whether it is a corporation or a trust).

5.2.2 Taxation issues relating to corporations

General principles

Where a special purpose corporation is used as a securitisation vehicle, the corporation is subject to the normal tax rules applying to corporations.

Deductions for losses and bad debts

An issue which sometimes needs to be considered is the ability of a special purpose corporation to claim deductions for prior and/or current year losses and bad debts. This is particularly important where the tax neutrality of the corporation depends upon the availability of such deductions. Generally, the ability to claim such deductions depends upon the corporation passing a “*continuity of ownership test*” or, in certain circumstances, a “*continuity of business test*”. The “*continuity of ownership test*” requires the tracing of controlling interests in the corporation

through interposed entities and the application of the test can become a particularly complex task if shares are held (directly or indirectly) in a corporation by discretionary or charitable trusts (which is often the case in securitisations).

5.2.3 Taxation issues relating to trusts

General principles

Tax will only be levied on the trustee of a trust where an Australian resident beneficiary is not presently entitled to the *net income* of the trust for tax purposes or where the trustee is taxed as a company for the purposes of Divisions 6B or 6C of the 1936 Tax Act. Securitisation trusts are usually structured so that a beneficiary is entitled to any income derived by the trust, with the intended effect that the trustee will not be personally liable for tax in respect of any income derived by the trust.

Where a securitised instrument is equity (ie. a unit in a unit trust), the taxation of any payments made will depend on whether these constitute redemptions of capital (which are not assessable) or distributions of income (which are assessable). Also, in certain circumstances, the trustee can be required to deduct tax from trust distributions to non-resident unit holders and remit this directly to the Commissioner of Taxation.

Taxation of trustees

Ordinarily, the accounting income of a securitisation trust will be the same as the net income of the trust for taxation purposes. However, in certain circumstances, it is possible that the “*net income*” of a trust for taxation purposes for an income year may exceed its accounting net income, for example, where the accounting income of a trust includes non-deductible expenditure. There are, basically, two conflicting views as to how the excess over the accounting “*net income*” is assessed.

Under the quantum approach, the beneficiary could only be entitled to such amount of income as he is entitled to receive and, if the net income of the trust exceeds the amount which he is entitled to receive, that excess is not income to which the beneficiary is presently entitled and is assessable to the trustee.

The proportionate approach regards the beneficiary’s share of accounting income as only being relevant to determining that beneficiary’s share of the net income of the trust for tax purposes. The operation of the proportionate method may require at least some income to have been derived by the trust in the year of income that is capable of being distributed to a beneficiary.

Despite the absence of an express approval by a Full Federal Court, the better view is that section 97 of the 1936 Tax Act should be interpreted using the proportionate approach. This is also generally the current position of the Australian Tax Office.

Taxation of trusts as companies

As indicated above, it is possible under Divisions 6B and 6C of the 1936 Tax Act for some trusts to be regarded as companies and for tax to be levied on the trustee (rather than the beneficiaries).

Division 6B is unlikely to be relevant for securitisation trusts (it usually only applies where, as part of a corporate reorganisation, the property of a company is transferred to a public unit trust and shareholders in the company become entitled to take up units in the trust).

On the other hand, Division 6C can, in some circumstances, apply to securitisation trusts. Under section 102S, the trustee of a public trading trust is taxable on the net income of the trust. Section 102N provides that a unit trust is a trading trust if (among other things), it "carries on a trading business or, in the year of income, it controlled or was able to control, the affairs or operations of another person in respect of the carrying on by that person of a trading business."

A "trading business" is defined in section 102M to mean a business "that does not consist wholly of *eligible investment business*", which in turn includes:

"(a) investing or trading in any or all of the following:

- (i) secured and unsecured loans (including deposits with a bank, building society or other financial institution);*
- (ii) bonds, debentures, stock or other securities ..."*

As can be seen, an eligible investment business specifically refers to the making of both secured and unsecured loans.

5.2.4 Trust loss provisions

Background

In some circumstances a securitisation vehicle may incur losses or bad debts which it wishes to claim as a deduction. In ascertaining whether a trust can claim a deduction for losses or bad debts, different tests apply depending upon whether the trust is a fixed trust (where all the income and capital of the trust are the subject of fixed entitlements) or a non-fixed trust (all trusts other than fixed trusts).

The tests which must be passed by a non-fixed trust in order to claim deductions for prior and current year losses and bad debts

are generally more difficult to pass than those applicable to fixed trusts. For that reason, and because of the issues discussed above relating to the taxation of the trustees, it is usual, so far as possible, that trust securitisation vehicles are structured as fixed trusts.

Different types of trusts

For fixed trusts, deductions will be denied for tax losses and bad debts if there is no longer a continuity of the majority (ie. more than 50 percent) of the beneficial ownership of the trust (the 50 percent stake test). Ordinary fixed trusts have to apply the 50 percent stake test whenever they wish to claim deductions for tax losses and/or bad debts.

Different rules apply in respect of certain unit trusts. Widely held unit trusts have to test ownership when there is any abnormal trading in the units of the trust or, in some cases, at the end of an income year. Listed widely held unit trusts can avoid the consequences of failing the ownership test if they pass the same business test.

In respect of non-fixed trusts, deductions for losses and/or bad debts will be denied if the 50 percent stake test is failed or if control (broadly defined) of the non-fixed trust changes or, in some circumstances, if there is a 50 percent or greater change in the pattern of distributions of the income or capital of the trust.

The trust loss provisions do not apply to "*excepted trusts*" which are defined to include fixed unit trusts where the beneficiaries are all persons whose income is exempt from tax under section 23 of the 1936 Tax Act or Division 50 of the 1997 Tax Act.

Fixed trusts with non-fixed trust beneficiaries

The relevant tests are more stringent for fixed trusts where the beneficiaries who are entitled to more than 50 percent of the trust income or capital are, in turn, non-fixed trusts (such as charitable trusts or discretionary trusts). In these circumstances, the non-fixed trust beneficiaries must have held fixed entitlements to a 50 percent or greater share of the income or capital of the fixed trust during the whole of the relevant test period and must pass a "*pattern of distributions test*" and a "*control test*".

Briefly, the "*pattern of distributions test*" requires that 50 percent or more of the distributions made by the non-fixed trust have been to the same individuals (meaning natural persons) for their own benefit during the six year period prior to the year of income in question.

The “control test” is a very broad test. It generally applies where a group (meaning a person and/or his or her associates) either alone or together “begins to control” the trust directly or indirectly.

This means that changes in the ownership or control of the trustees of a non-fixed trust could cause the non-fixed trust to fail the “control test” and hence the underlying fixed trust will be unable to claim deductions for losses and bad debts. This issue is particularly important where it is intended that a securitisation trust will have a charitable or discretionary trust as its beneficiary. Changes of control of the beneficiary, and the trustee of the beneficiary, can affect the tax treatment of the securitisation trust itself.

Taxation of trusts: Ultimate beneficiary non-disclosure tax

Division 6D of Part III of the 1936 Tax Act contains the provisions on ultimate beneficiary non-disclosure tax. The object of these provisions is to enable the Commissioner to check whether the assessable income of the ultimate beneficiaries correctly includes any required share of the relevant net trust income, and whether the net assets of the ultimate beneficiaries reflect the receipt of certain tax-preferred amounts. Where the provisions apply, and the trustee fails to correctly identify the ultimate beneficiaries, the trustee incurs a tax liability at the rate of 48.5 percent and may commit an offence under the *Taxation Administration Act* 1953.

The Commissioner has released Practice Statement PS 2001/12 with effect from 5 September 2001 dealing with the requirements of trustees to provide ultimate beneficiary statements in specified circumstances. Practice Statements are not legally binding on the Commissioner, however they are treated as “administratively binding”.

5.2.5 Timing of interest receipts from underlying asset

Interest paid to a securitisation vehicle on its underlying assets will normally be assessable when received. However, if its activities can be characterised as akin to that of a “financial institution”, then interest income may be recognised on a full accruals basis for tax accounting purposes. Taxation Ruling TR 93/27 outlines the Commissioner’s views as to what is meant by a financial institution. Broadly, the Commissioner believes that a “financial institution” is “any institution, one of whose principal activities is to take deposits and borrow, with the object of lending and investing”.

The Commissioner accepts that most securitisation vehicles are akin to financial institutions and can recognise interest income on a full accrual basis.

5.2.6 Timing of interest expenses

The decision in *FC of T v Australian Guarantee Corporation* 84 ATC 4642 confirms that interest deductions for a taxpayer accrue from day to day and thus are deductible on that basis, even where interest is not payable until the end of the relevant calculation period. This rule extends to all payments of interest by business taxpayers, and, therefore, applies generally to all securitisation vehicles.

5.2.7 Timing of swap transaction payments and receipts

The tax treatment of any swap transaction entered into by a securitisation vehicle will be determined in accordance with Income Tax Ruling IT 2682 (as modified by the Draft Taxation Ruling TR 1999/D13). This provides that for bona fide swaps, payments in arrears in respect of defined periods are to be accounted for on an accruals basis, whilst payments in advance are to be deducted on a paid basis. A consistent approach is also to be adopted for receipts under swaps.

5.2.8 Timing of gains and losses in respect of underlying assets

Different types of investments and assets held by a securitisation vehicle may give rise to the recognition of assessable income and deductions at different times. For example, gains in respect of some securities with deferred yields must be recognised on a full accruals basis, whereas gains and losses in respect of securities which qualify as traditional securities are not recognised until the year of income in which such securities are disposed of or redeemed. Accordingly, investments and assets held by a securitisation vehicle should be selected and managed carefully in order to ensure that tax symmetry arises where possible.

5.2.9 The taxation treatment of management fees

If the management fees payable by a securitisation vehicle have been calculated on an arm’s length basis, they should be deductible according to ordinary principles under section 8-1. However, if they are commercially unrealistic or can be construed as being a payment designed to represent a distribution of profit rather than an expense incurred in deriving income, there is a risk that the fees will not be deductible. This in turn could affect the tax neutrality of the securitisation vehicle.

Of particular interest in this regard is the decision in *United Energy Limited v FC of T* 97 ATC 4796. The Full Federal Court considered that franchise fees payable by certain companies that were calculated by reference to a reasonable estimation of the amount by which the income of those companies was likely to exceed a particular level were, in reality, akin to payments of a

share of the profits of the companies, rather than costs incurred by the companies in the process of deriving assessable income and were not, therefore, deductible. The decision is similar in this respect to the recent Full Federal Court decision of *City Link Melbourne Limited v Federal Commissioner of Taxation* [2004] FCAFC 27; taken together, the decisions highlight the potential income tax difficulties where a management fee could be construed as being used to remove potential profit (or excess income) from a securitisation structure.

5.2.10 New collection procedures

Under collection procedures introduced from 1 July 2000, a special withholding tax is imposed where a supply is provided by a business (including the lending of money) that fails to quote an Australian Business Number (ABN). If no ABN is provided, the party paying for the services is required to withhold 48.5 percent of the payment.

5.3 Interest withholding tax and securitisation

5.3.1 Background

Under section 128B of the 1936 Tax Act, a non-resident of Australia who derives interest from a resident must pay tax on that interest at a flat rate of 10 percent. This tax must be withheld by the resident payer of the interest.

This means that an Australian securitisation vehicle must, unless it falls within an exemption under the Tax Act, deduct interest withholding tax (IWT) from interest payments to non-resident holders of those securities. Since an issue of securities which is liable to interest withholding tax is not commercially feasible, it is important for securitisers who wish to issue offshore to fall within one of the exemptions to IWT. Similarly, if a domestic issuer (including an Australian permanent establishment of a non-resident) wishes to widen the pool of potential investors by including foreign purchasers, its securities will need to be exempt from IWT in their hands.

The exemption from IWT is contained in section 128F of the Tax Act and is supplemented by a number of Taxation Determinations; TD1999/8-26 (inclusive); and TD2001/3.

5.3.2 The current exemptions overview

Interest paid by a company on debentures will be exempt from IWT if all of the following conditions are satisfied (section 128F(1)):

- the company was a resident of Australia or an Australian permanent establishment of a non-resident when it issued the debentures;

- the company is a resident of Australia or an Australian permanent establishment of a non-resident when the interest is paid;
- the issue of the debenture satisfies one of the public offer tests set out in sections 128F(3) and (4);
- the issue does not fail the public offer test under subsection 128F(5), discussed at 5.3.5; and
- as provided in section 128F(6) no interest is paid to a known associate of the company, discussed at 5.3.3.

Definition of interest

“Interest” is defined in section 128A(1AB) as follows:

“Interest includes an amount, other than as set out in section 26C(1):

- (a) that is in the nature of interest; or*
- (b) to the extent that it could reasonably be regarded as having been converted into a form that is in substitution for interest; or*
- (c) to the extent that it could reasonably be regarded as having been received in exchange for interest in connection with a washing arrangement; or*
- (d) that is a dividend paid in respect of a non-equity share.*

but does not include an amount to the extent to which it is a return on an equity interest in a company.”

A “washing arrangement” for the purpose of paragraph (c) is defined to mean an “arrangement under which the title to a security is transferred to a resident shortly before an interest payment is made where the sole or dominant purpose of the arrangement is to reduce the amount of withholding tax payable by a person”.

Sections 128A(1AC)-(1AF) provide clarification of what constitutes interest. This includes a discount on a security and a lump sum payment made instead of payment on interest. If a lender assigns a loan, or the right to interest under a loan, any payment from the borrower to the assignee that represents an amount that would have been interest had the assignment not taken place, is to be taken as interest. Also, if a person acquires a security on a cum-interest basis, any payment by the issuer to that person that would have been interest if the acquisition had not taken place is taken to be a payment of interest.

Sections 128AA, 128AC and 128AD contain specific deeming provisions which can have the effect of requiring certain amounts in connection with discounted securities, offshore hire purchase arrangements and bills of exchange being treated as interest.

Definition of debenture

A “debenture” in relation to a company is defined in section 6(1) to include “debentures stock, bonds, notes and any other securities of the company, whether constituting a charge on the assets of the company or not”. Section 128F(9) specifically provides that a debenture includes a promissory note and a bill of exchange.

Definition of company

The exemption in section 128F(1) only applies to a company. This is given an extended meaning in section 128F(9) and includes a company in the capacity of a trustee of a resident trust estate if:

- “(a) the trust is not established by a will, or instrument of trust, for public charitable purpose; and*
- (b) the only person who is capable (whether by the exercise of a power of appointment or otherwise) of benefiting under the trust is a company other than a company in the capacity of trustee.”*

The extended definition permits a securitisation trust (provided it satisfies the requirements of paragraphs (a) and (b) above) to qualify for the exemption from IWT.

In circumstances where the section 128F(1) definition of a company is not satisfied, the issuer should have regard to the new section 128FA which extends the operation of the section 128F exemption to interest payments made by eligible unit trusts. The section 128FA exemption broadly replicates the debenture issue conditions in section 128F (most importantly, the public offer test discussed in Part 5.3.3 below).

For exemption purposes, an eligible unit trust is to be a public unit trust or a unit trust in which all of the issued units are held by two or more “eligible unit holders” (i.e. public unit trusts, complying superannuation funds with 50 or more members, PSTs, complying ADFs, life companies, public companies or other unit trusts which satisfy this requirement).

5.3.3 The public offer tests

There are six public offer tests. An issuer must satisfy one of the public offer tests in order to qualify for the section 128F exemption from IWT.

Section 128F(3) sets out five of the public offer tests. It provides that an issue of a debenture satisfies the public offer test if the issue results from the debenture being offered for issue:

- “(a) to at least 10 persons, each of whom:*
 - (i) was carrying on a business of providing finance, or investing or dealing in securities, in the course of operating in financial markets; and*
 - (ii) was not known, or suspected by the company to be an associate (see subsection (9)) of any of the other persons covered by this paragraph; or*
- (b) to at least 100 persons whom it was reasonable for the company to have regarded as either:*
 - (i) having acquired debentures in the past; or*
 - (ii) being likely to be interested in acquiring debentures; or*
- (c) as a result of being accepted for listing on a stock exchange, where the company had previously entered into an agreement with a dealer, manager or underwriter, in relation to the placement of debentures, requiring the company to seek such listing; or*
- (d) as a result of negotiations being initiated publicly in electronic form, or in another form, that was used by financial markets for dealing in debentures; or*
- (e) to a dealer, manager or underwriter, in relation to the placement of debentures who, under an agreement with the company, offered the debentures for sale within 30 days in a way covered by any of paragraphs (a) – (d).”*

Section 128F(4) also provides that the issue of a debenture by a company satisfies the public offer test if the debenture is a global bond.

Section 128F(10) provides that a debenture is a “global bond” if:

- “(a) it describes itself as a global bond or a global note;*
- (b) it is issued to a clearing house (see subsection (9)) or to a person as trustee or agent for, or otherwise on behalf of, one or more clearing houses; [for this purpose a clearing house is defined as a person who operates a facility that is used by financial markets for investing in or dealing in securities (section 128F(9)); and*
- (c) in connection with the issue, the clearing house or houses:*
 - (i) confer rights in relation to the debenture on other persons; and*
 - (ii) record the existence of the rights;*

(d) before the issue:

(i) the company; or

(ii) a dealer, manager or underwriter, in relation to the placement of debentures, on behalf of the company, announces that, as a result of the issue, such rights will be able to be created

(e) the announcement is made in a way or ways covered by any of paragraphs (3)(a) to (e) by reading a reference in those sections to "debenture" as if it were a reference to such a right, and a reference to the "company", as if it included a reference to the dealer, manager or underwriter; and

(f) under the terms of the debenture, interests in the debenture are able to be surrendered, whether or not in particular circumstances, in exchange for other debentures issued by the company that are not themselves global bonds."

5.3.4 Certain issues of debentures will always fail the public offer test

Section 128F(5) provides that a company issuing a debenture will fail the public offer test if, at the time of the issue, it knew, or had reasonable grounds to suspect, that the debenture or an interest in the debenture, was being, or would later be, acquired (either directly or indirectly) by an associate of the company, other than in the capacity of a dealer, manager or underwriter in relation to the placement of the debenture.

Section 128F(9) gives "associate" the same meaning as in the controlled foreign companies provisions in section 318 of Part X of the 1936 Tax Act (with some minor modifications relating to partners in partnerships). For example, pursuant to section 318(2) companies are associated with each other if one of them (or its directors) "is accustomed or might reasonably be expected to act in accordance with the directions, instructions or wishes of the other; or one company is in a position to cast, or control the casting of, at least 50% of the votes in the other".

Even in circumstance where the debenture is acquired directly or indirectly by an associate, the public offer test will only be failed under subsection 128F(5) if:

- the associate is a non-resident and the debenture or interest was not being, or would not be, acquired by the associate in carrying on a business in Australia at or through a permanent establishment of the associate in Australia; or

- the associate is a resident of Australia and the debenture or interest was being, or would be, acquired by the associate in carrying on a business in a country outside Australia at or through a permanent establishment of the associate in that country.

Notwithstanding the above, subsection 128F(6) will still operate to disqualify the operation of section 128F if:

- the interest on the debentures is paid to an associate of the company in respect of a debenture acquired broadly in carrying on business outside Australia; and
- the payment is not received in the capacity of a custodian and funds manager.

This subsection applies even where the primary issue of the debentures satisfies the other general requirements to section 128F (eg. the associate test in subsection 128F(5)).

5.3.5 The non-resident borrowing subsidiary exemption

An exemption for wholly-owned non-resident special purpose finance subsidiaries, which issue debentures outside Australia and on-lend the proceeds to a parent company in Australia, is provided in section 128F(8).

The exemption will generally apply if:

- "(a) the parent company beneficially owns all of the issued shares in the capital of a company that is not a resident of Australia;*
- (b) the subsidiary's only business is raising finance for the purposes of the parent company;*
- (c) the subsidiary raises finance in a country specified in the regulations (but not Australia) by issuing a debenture in that country; and*
- (d) when the debenture is issued, the subsidiary is treated as a resident of that country for the purposes of the tax laws of that country."*

The subsidiary must raise finance in a listed country. At this stage, the United States of America is the only listed country.

5.3.6 Anti-avoidance provisions

The general anti-avoidance provisions in Part IVA of the 1936 Tax Act may be applied to schemes to avoid withholding tax. The result is that the Commissioner can make a determination that IWT has not been paid in relation to the payment of interest by a resident and that a non-resident tax payer has received a tax

benefit. The Commissioner can then impose withholding tax calculated on the tax benefit together with possible additional tax of 25 percent or 50 percent depending upon whether the payer has a reasonably arguable case.

A specific anti-avoidance provision deems amounts of interest paid by an Australian resident through a tax-exempt interposed entity to a non-resident recipient, to have been paid by the resident directly to a non-resident. Payments made in such a manner are therefore be subject to IWT.

5.3.7 Commentary on the revised IWT exemptions

While the revised IWT exemptions provide a number of positive reforms for the securitisation industry, a number of difficulties have been encountered with the implementation of the provisions in practice.

Causal connection between the offering and issue of securities

Section 128F(3) provides that the issue of the relevant debentures must result from the debentures being offered by one of the means set out in the section. There must therefore be a causal connection between the method of offering and the actual issue of the debentures. Where debentures are issued which do not satisfy this causal connection, then they will not, strictly speaking, be eligible for the IWT exemption.

For example, say debentures were offered to 10 sophisticated investors in the manner contemplated by section 128F(3)(a) (see above), but those debentures were actually issued to others (because the 10 sophisticated investors did not take up their offers). In these circumstances, it is difficult to conclude that the debentures were issued as a result of being offered to the 10 sophisticated investors. They were issued as a result of being offered to the others who then accepted their offers. Strictly speaking, therefore, even though the debentures were initially offered in a way complying with section 128F(3)(a), the causal connection requirement was not satisfied and the debentures do not qualify for the IWT exemption.

There are also other potential problems posed by the causal connection requirement. Where debentures are listed for the purposes of section 128F(3)(c) (eg. on the London or Luxemburg stock exchanges), it may be difficult to conclude that the debentures were issued as a result of the listing. Listing is part of the overall process, and is perhaps a condition precedent to the issue, but usually it is one of many conditions precedent. Also, where debentures are offered for sale on Reuters or Bloomburges for the purposes of section 128F(3)(d), but are acquired by persons as a result of direct offers by way of telephone who

were unaware of the electronic offer (eg. because they do not receive Reuters or Bloomburges), then it may be said that the debentures were not issued as a result of *“negotiations being initiated publicly in electronic form”*.

In response to these difficulties, the Australian Taxation Office (ATO) issued Taxation Determination TD 1999/8. In the Determination, the ATO held that it would administer section 128F(3) on the basis that a debenture will be taken to have resulted from being offered for issue if the debenture satisfies one of the paragraphs set out in section 128F(3) (ie. in effect, the statutory causal connection requirement can be ignored).

Dealer compliance with the IWT exemption requirements

Ideally, an issuer will wish its dealer panel to covenant that they will offer and issue the debentures in a manner that complies with the IWT exemption requirements. Some dealers are prepared to do this; however others either give covenants that stop short of full compliance or are not prepared to give any undertakings as to the manner of offer and issue, arguing that they should not be required to change their standard procedures and that the issuer should satisfy itself that they comply with the IWT exemption requirements. In this regard, there are a number of provisions that are of regular concern to dealers. If a transaction is relying on section 128F(3)(a) (through section 128F(3)(e)), the issuer will want to know that a dealer’s clients to whom the securities are being offered are *“carrying on a business of providing finance, or investing or dealing in securities, in the course of operating in financial markets”*. Also an issuer will want an assurance that none of these investors are *“associates”* of each other for the purposes of section 128F(3)(a) or, generally, an associate of the issuer for the purposes of section 128F(5).

While one can be sympathetic to the position of international dealers, if issuers do not receive the requisite assurances from them, they are placed in a very difficult position.

They have no certainty that their securities qualify for the IWT exemption. Under the self assessment system, it may be many years before the Commissioner of Taxation concludes that the debentures did not so qualify, at which point the securitisation vehicle is likely to have accrued a substantial unfunded interest withholding tax liability.

5.3.8 Conclusion

While there are some issues in relation to the practical implementation of the IWT exemptions in section 128F, overall they have opened up the international capital markets to Australian securitisers.

5.4 Debt/equity rules

Division 974 of the 1997 Tax Act contains rules which define the debt/equity borderline for tax purposes.

Where notes used to fund a securitisation vehicle are regarded as equity for tax purposes, interest on the notes is not deductible which may disrupt the tax neutrality of the securitisation vehicle. The notes will only be treated as equity interest where they bear a return which is contingent on the economic performance of the issuer or they are convertible into equity interests.

5.5 Thin capitalisation

Division 820 of the 1997 Tax Act contains Australia's thin capitalisation rules and applies to Australian resident entities that are foreign controlled, to Australian controllers of foreign entities and to Australian entities that carry on business through an overseas branch (as well as certain foreign entities).

There is an exemption from the thin capitalisation measures for certain special purpose entities. In order to qualify for this exemption, the following conditions must be met:

- the entity must be established for the purposes of managing some or all of the economic risk associated with assets, liabilities or investments (whether the entity assumes the risk from another entity or creates the risk itself);
- at least 50 percent of the entity's assets are funded by debt interests; and
- the entity is an "insolvency remote special purpose entity" according to the criteria of an internationally recognised rating agency applicable to the entity's circumstances.

As noted in the Explanatory Memorandum, the exemption for special purpose entities seeks to cover "a broad and ever expanding range of securitisation activity and structures."

5.6 Foreign exchange gains/losses

From 1 July 2003, the foreign exchange rules may apply to the securitisation vehicle if certain events ("forex realisation events") happen. Subject to certain exceptions, if the securitisation vehicle makes a gain from a forex realisation event, it must include that gain in its assessable income, if it makes a loss from a forex realisation event, that loss is an allowable deduction.

Short term forex realisation gains and losses (less than 12 months) are covered by special rules, in section 775-70 of the 1997 Act and section 775-75 of the 1997 Act.

There is an election in section 775-80 of the 1997 Act in respect of these special rules.

Generally, the operation of those rules is positive in the sense that it should enable a matching of foreign exchange gains with foreign exchange losses to maintain neutrality through the conduit structure. However, there is a technical defect in the rules which could produce timing mismatches.

The issue can potentially arise because the income derived by the conduit will invariably be recognised for tax purposes on a daily accruals basis. The funding expense will also be recognised on a daily accruals basis. However, the exchange loss which will typically arise on a swap or forward foreign currency purchase (for principal) will only be realised (and thus tax deductible) upon maturity of that hedging transaction.

Therefore, if a swap is realised after the financial year end, then the deduction will not be crystallised until after year end and, to the extent that the corresponding income has been accrued as at year end, a mismatch will arise.

5.7 Consolidation

The tax consolidation system applies to 100 percent owned groups of companies and, relevantly for securitisation, trusts. Where consolidation is elected, the ultimate Australian resident holding company (the Head Company) is treated as the only tax entity. The separate entity status of wholly owned companies and trusts is ignored – their businesses are regarded as divisions of the Head Company. Where consolidation is elected members of the consolidated group cannot be selectively included or excluded from consolidations. The "one in all in" principle requires all wholly owned entities to be consolidated.

Where a securitisation vehicle is a wholly owned entity within a group which has elected to consolidate, it will form part of a consolidated group. This could have significant tax consequences as tax neutrality will not be determined in respect of a special purpose vehicle as a stand alone entity. Instead, a single tax liability would be determined by reference to the consolidated group, treated as a single entity.

There are specific rules dealing with the recovery of income tax owing by the Head Company of the consolidated group, where the Head Company defaults on its primary obligation for the income tax debts of the consolidated group. A group member will be jointly and severally liable for all the tax liabilities of the group.

The Head Company can change this result by entering into a tax sharing agreement with one or more of the group members. The tax sharing agreement would seek to determine tax liabilities of group members so that, say, a securitisation trust was not burdened with the tax liabilities of other group members. A tax sharing agreement must make a reasonable allocation of group tax liabilities. Regulations will be created that set out further requirements (if any) for such an agreement. A tax sharing agreement will only be enforceable against the Commissioner if the agreement was not entered into for the purpose of prejudicing the Commissioner's recovery powers.

Where a securitisation vehicle is not wholly owned then the consolidation rules will not be relevant.

5.8 Goods and services tax issues relevant to securitisation

5.8.1 Overview

A goods and services tax (GST) was introduced into Australia on 1 July 2000. GST is imposed on supplies including the provision of goods, services, rights or information. A supply may be outside the scope of GST because the supply is not connected with Australia or because the supply is made by an entity that is not registered or required to be registered for GST purposes. Other supplies may not give rise to a GST liability because the supply belongs to a class of supply that is identified by the GST law as being excluded from the definition of "taxable supplies".

5.8.2 Input tax credits

As is typical of GST and VAT systems, under the Australian GST system, registered GST entities may claim a credit for the GST included in the price paid for goods and services acquired for the business purposes of that entity. Such credits are known as input tax credits. No input tax credit may be claimed to the extent that the acquisition is made for a private or domestic purpose of the entity. As discussed below, further limitations exist on the ability of an entity to claim input tax credits to the extent an acquisition relates to input taxed supplies (such as financial supplies) being made by the entity.

5.8.3 Types of supplies

A number of different types of supplies are specifically identified in the Australian GST system. There are three principal categories of supplies that are identified:

- taxable supplies;
- GST-free supplies; and
- input taxed supplies.

Taxable supplies

GST is payable by a registered GST entity on the taxable supplies made by that entity. A supply will constitute a taxable supply if the following requirements in section 9-5 of the *A New Tax System (Goods and Services Tax) Act 1999* (the GST Act) are satisfied:

- "(a) the supply is made for consideration;*
- (b) the supply is made in the course or furtherance of an enterprise that the supplier carries on;*
- (c) the supply is connected with Australia; and*
- (d) the supplier is registered or required to be registered."*

All such supplies will be taxable except to the extent that the supply is identified by the GST law as either GST-free or input taxed.

GST-free supplies

GST is not payable on supplies that are GST-free. Most supplies in the context of securitisations will be supplies of "things" other than goods or real property. Such supplies would include services and most debt instruments (other than the mortgages themselves). Such supplies will be GST-free if the following requirements are satisfied:

- (a) the supply is made to a non-resident who is not "in Australia" when the thing supplied is done, and either:
 - (i) the supply is neither a supply of work physically performed on goods situated in Australia when the work is done, nor a supply directly connected with real property situated in Australia; or
 - (ii) the non-resident acquires the thing in carrying on its enterprise, but is not registered or required to be registered (refer Item 2 of section 38-190(1) of the GST Act); or
- (b) the supply is made to a recipient who is not "in Australia" when the thing supplied is done and the effective use and enjoyment of the supply takes place outside Australia other than a supply directly connected with real property situated in Australia (refer Item 3 of section 38-190(1) of the GST Act).

Therefore, a determination of whether or not an entity is "in Australia" will be critical in determining whether or not a supply is to a non-resident will be GST-free. Detailed guidance of the Australian Taxation Office's views are set out in GST Ruling GSTR 2004/7.

Entities that make GST-free supplies will be entitled to input tax credits for the GST components included in the cost of their acquisitions that relate to the making of those supplies.

Input taxed supplies

GST is not payable on supplies that are input taxed. The distinction between input taxed supplies and GST-free supplies (discussed above) is that an entity may be restricted in its ability to claim input tax credits because of the input taxed supplies made by that entity.

There are two main types of input taxed supplies, namely input taxed financial supplies and other input taxed supplies (such as the leasing of residential premises). Generally, an entity will be unable to claim any input tax credits for acquisitions, to the extent they relate to the making of input taxed supplies. However, there are three important exceptions in relation to input taxed financial supplies.

First, a reduced input tax credit may be claimed for reduced credit acquisitions which relate to making financial supplies.

The reduced input tax credit is a credit equal to 75 percent of the GST included in the consideration provided by the entity for that acquisition. Reduced input tax credits are only available for the reduced credit acquisitions that are exhaustively listed in the GST law.

Secondly, an entity will not be precluded from claiming an input tax credit for an acquisition to the extent the acquisition relates to the making of financial supplies and the entity making the acquisition does not exceed the financial acquisitions threshold. An entity will exceed the financial acquisitions threshold if either:

“(a) the amount of all input tax credits to which that entity would be entitled for ‘financial acquisitions’ would exceed \$50,000; or

(b) the amount of input tax credits to which that entity would be entitled for ‘financial acquisitions’ would exceed 10% of the total amount of the input tax credits to which the entity would be entitled for acquisitions and importations during that 12 month period.”

Therefore, the question of whether or not an entity exceeds the financial acquisitions threshold turns not on the value of financial supplies made by that entity but rather, the value of the acquisitions made by that entity that are attributable to those financial supplies.

Finally, an entity will not be denied an input tax credit for acquisitions that are made in the course of making a financial

supply consisting of a borrowing, provided that the borrowing is not for the purpose of making input taxed financial supplies. Further, such acquisitions will not be counted in determining whether or not the entity making the acquisition exceeds the financial acquisitions threshold.

Financial supplies

Of the categories of input taxed supplies, the most significant in the context of securitisations are the input taxed financial supplies. The Australian GST system only provides input taxed treatment for financial supplies that involve the provision, acquisition or disposal of various interests. Services relating to the making of financial supplies, such as arranging services, are not provided with input taxed treatment and will generally be taxable.

Regulation 40-5.09 of the *A New Tax System (Goods and Services Tax) Regulations 1999* (the “GST Regulations”) defines the scope of financial supplies. Pursuant to subparagraph (1) of that regulation, the provision, acquisition or disposal of an interest mentioned in subparagraph (3) or (4) is a financial supply if:

“(a) the provision, acquisition or disposal [of the interest] is:

(i) for consideration;

(ii) in the course or furtherance of an enterprise; and

(iii) connected with Australia; and

(b) the supplier is:

(i) registered or required to be registered; and

(ii) a financial supply provider in relation to the supply of the interest.”

Because financial supplies are input taxed, entities that make financial supplies are not liable to remit GST on the value of those supplies. Subject to the exceptions identified above, entities will be restricted in their ability to claim input tax credits for acquisitions relating to the making of financial supplies.

Regulation 40-5.12 of the GST Regulations sets out a table of supplies that are specifically identified as not being input taxed financial supplies. These supplies will be taxable provided that they are not incidental financial supplies (discussed below) and provided that the general requirements of a taxable supply are satisfied.

In the event of any conflict between regulations 40-5.09 and 40-5.12, regulation 40-5.12 will prevail – that is, the supply not be an input taxed financial supply.

Incidental financial supplies

Pursuant to regulation 40-5.10 of the GST Regulations, even if a supply is not a financial supply pursuant to regulation 40-5.12, it may be input taxed as an incidental financial supply where it is supplied directly in connection with a financial supply.

In order for a taxable supply to be supplied directly in connection with a financial supply, the taxable supply must be:

- incidental to the financial supply;
- supplied, at or about the same time as the financial supply, but not for separate consideration; and
- usually supplied together with the financial supply in the ordinary course of the supplier's enterprise.

The Australian Taxation Office has provided detailed guidance on its views on many issues relating to financial supplies in a public ruling, GSTR 2002/2, including:

- those supplies that will be input taxed financial supplies;
- those supplies that will be excluded from being input taxed financial supplies under regulation 40-5.12;
- those acquisitions that will be reduced credit acquisitions; and
- the requirements for a supply to be an incidental financial supply.

5.8.4 Reverse charging

In most cases, it is the entity making the supply that will be liable to remit any GST payable on that supply. However, the GST law provides that in some cases the recipient may choose to assume the supplier's GST liability and in other cases, the GST law imposes a liability to remit GST on the recipient. The latter case is particularly relevant for securitisations in which services are provided from entities outside Australia. Under Division 84 of the GST Act, an entity that is registered for GST purposes in Australia may be liable to remit GST on supplies that it receives where:

- the supply that is made to that entity is *not connected with Australia*; and
- the supply would not have been *GST-free* or *input taxed* if it had been connected with Australia; and
- the entity acquires the supply solely or partly for the purpose of an enterprise that it carries on in Australia, but not solely for a creditable purpose; and
- the supply is for consideration.

Where these conditions are met, the recipient will be liable to GST equal to 10 percent of the amount paid for the relevant acquisition.

Notably, this liability may also be imposed on transfers (not amounting to supplies) between branches of the same entity – such as the provision of broking services to an Australian branch by a branch of the same entity in another country.

5.8.5 Registration under the GST Act

In order for an entity to make taxable supplies, financial supplies and creditable acquisitions, the entity must be registered or required to be registered under the GST Act. Pursuant to section 23-5 of the GST Act, an entity is required to be registered if it makes supplies which are connected with Australia in the course of carrying on its enterprise and its annual turnover as defined in section 188-10(1) of the GST Act, is or exceeds the registration turnover threshold of \$50,000.

However, notably the value of any input taxed supplies made by the entity are excluded from its turnover for the purposes of this calculation.

Provided that an entity is carrying on an enterprise, it may elect to register if its turnover is below the mandatory registration threshold. Failure to register an entity within 21 days of the entity becoming required to be registered is an offence, liable to an administrative penalty under section 228-40 of Schedule 1 to the *Taxation Administration Act*.

Relevant definitions

There are a number of important definitions to be considered in determining whether or not an entity is entitled to be registered under the GST Act:

- “connected with Australia” is specifically defined in section 9-25 of the GST Act and depends on whether the supply is of goods, real property or anything else (eg. a supply of anything other than goods or real property is connected with Australia if either the thing is done in Australia, or the supplier makes the supply through an enterprise that the supplier carries on in Australia);
- “entity” is defined in section 184-1 of the GST Act and includes all kinds of legal persons, as well as legal constructs such as trusts and partnerships;
- “carrying on” an enterprise is defined in section 195-1 of the GST Act to include the doing of anything in the course of the commencement or termination of the enterprise;

- “enterprise” is defined in section 9-20(1) of the GST Act to include an activity, or series of activities, done in the form of a business, or in the form of an adventure or concern in the nature of trade; and
- “annual turnover” in relation to meeting the annual turnover threshold is specifically defined in section 188-10(1) of the GST Act in terms of “current annual turnover” and “projected annual turnover”. Current annual turnover is the sum of the value of all the supplies the entity has made, or is likely to make, during the 12 months ending at the end of a particular month, and projected annual turnover is the sum of the value of all of the supplies the entity has made, or is likely to make, during a particular month and the next 11 months. However, supplies that are input taxed, not made for consideration, not made in connection with an enterprise that the entity carries on, and not connected with Australia are disregarded in those calculations.

Registration of a securitisation trust

Where a trust structure is used as the securitisation vehicle, the trust will generally constitute an entity that carries on an enterprise for the purposes of registration under the GST Act. This is despite the fact that such a trust usually would not have independent resources other than assets being securitised which are dedicated to the financial requirements of the relevant securities. However, the trust will have been created for commercial reasons, and subscriptions to the trust, usually in the form of marketable securities, are sold via marketing activity to attract funds. Those characteristics are indicators of commerciality which together entitle the trust to register under the GST Act. It should also be borne in mind that a trust and a trustee (in its capacity of trustee of the trust) are considered to be separate entities for GST purposes, and therefore the trustee is able to make supplies to the trust.

5.8.6 Typical GST outcomes in a securitisation structure

Set out below are the general GST implications of typical transactions which are made by entities involved in a securitisation structure:

- *management services*: a taxable supply
- *the creation and servicing of a mortgage*: a financial supply
- *the issue of a debt security*: a financial supply
- *the transfer of a debt or an interest in a debt*: a financial supply
- *the issue of units in a trust*: a financial supply.

However, it should be borne in mind that each transaction document should be specifically analysed to determine the GST implications of supplies which will be made pursuant to that document. The Australian Taxation Office has published its views on some of the GST consequences arising under a typical securitisation arrangement (including the availability of any Reduced Input Tax Credits) in GSTR 2004/4 *Goods and Services tax: assignment of payment streams including under a securitisation arrangement*.

5.8.7 Conclusion

As a transaction tax, management of GST is critical within the securitisation structure. This will include:

- appropriate classification of the supplies that are being made;
- a determination of whether input tax credits or reduced input tax credits will be available for the acquisition of any taxable supplies; and
- ensuring entities within the structure are entitled to be registered for GST purposes.

5.9 Future developments

Following is a brief summary of various aspects of tax law which have been identified as areas which may be changed in the future, as well as an analysis of their impact on securitisation programs.

5.9.1 New withholding tax regime

The Australian Commonwealth Parliament has introduced certain obligations to withhold an amount in respect of certain payments and non-cash benefits that are provided to foreign residents on or after 1 July 2003.

The withholding provisions apply to payments as prescribed by regulations to be progressively introduced from 1 July 2003.

According to the Explanatory Memorandum to the non-resident withholding tax regime, the regulations which prescribe the relevant payments and the relevant withholding rates under the non-resident withholding provisions will be progressively made where there is a demonstrated compliance risk and after consultation with affected taxpayer groups. Regulations introduced to date (covering casino gaming junket arrangements, entertainment and sports activities and construction contract) will not affect the chosen securitisation vehicle.

This is consistent with the non-resident withholding provisions which provide that the regulations will not apply to interest and other payments which are already subject to the current withholding tax rules.

Furthermore, regulations may only be made where the Minister is satisfied that the payment could reasonably be related to assessable income of foreign residents.

5.9.2 Section 128F Extension

As part of the *Review of International Taxation in Australia*, the Australian Federal Government has proposed certain amendments to section 128F. If the proposed legislation is enacted in its present form, the section 128F interest withholding exemption will extend to interest paid on both “debentures” and any “debt interests” (as defined under the Australian income tax legislation) from the date of assent of the legislation, provided the relevant conditions are met.

The next section of this paper examines the impact of the Consumer Credit Code on Australian securitisation programs.

6 The Consumer Credit Code and securitisation

6.1 Introduction

The Consumer Credit Code (the Code) commenced operation in all States and Territories of Australia (other than Tasmania) on 1 November 1996. The Code commenced operation in Tasmania on 1 March 1997.

With few exceptions, the Code regulates all personal, domestic and household credit, including personal loans, housing loans, overdrafts, credit card facilities, credit and debt facilities (to the extent credit is provided), consumer leases, consumer hire purchase and retail credit. As a result, it affects many Australian securitisations including mortgage-backed programs.

6.2 The credit provider

The Code is directed primarily towards, and imposes obligations on, the actual provider of the regulated credit. In addition, but to a lesser extent, it also imposes obligations on and affects other parties involved in the lending process (eg. agents of credit providers, suppliers of goods and services purchased with credit and insurers).

The Code defines a credit provider as a “person that provides credit and includes a prospective credit provider”. Section 4 of the Code defines credit in the following terms:

“(1) For the purposes of this Code, credit is provided if under a contract:

- (a) payment of a debt owed by one person (the debtor) to another (the credit provider) is deferred; or*
- (b) one person (the debtor) incurs a deferred debt to another (the credit provider).”*

In securitisation programs using trusts or special purpose vehicles, a loan may be originated in two ways:

- *conduit programs* which involve an originator originating a loan with funds provided by a trustee or special purpose vehicle. The trustee or special purpose vehicle is the lender (or mortgagee) and under this arrangement is the credit provider for the purposes of the Code; or
- *assignment programs* where a lender lends money to a borrower and equitably assigns the resulting debt to a trustee or special purpose vehicle. The original lender in the credit provider. But does it remain the credit provider after the assignment or does the trustee or special purpose vehicle become the credit provider? This is answered by section 166 of the Code which provides:

“(1) If the rights of a credit provider under a credit contract, mortgage or guarantee are assigned or pass by law to another person, this Code from then on applies to that other person and does not impose any further obligation on the credit provider.

(2) The debtor, mortgagor or guarantor has and may exercise the same rights in respect of the credit contract, mortgage or guarantee against the assignee as the debtor, mortgagor or guarantor has against the credit provider.

(3) Subsection (1) does not apply while the credit provider continues to receive payments from the debtor, or would continue to do so if the debtor complied with the credit contract.”

Typically, the original lender remains the servicer of the assigned loans and the debtors are unaware of the assignment. As a result, section 166(1) will not apply to make the trustee or special purpose vehicle the credit provider (see section 166(3)). Debtors are normally only be given notice of the assignment if the trustee or special purpose vehicle perfects its title to the loans (ie. it takes a legal assignment of the loans). If it does so, the trustee or special purpose vehicle will then become the credit provider.

6.3 Failure to comply with the Code

The consequences to a credit provider for failing to comply with the requirements of the Code can be divided into five categories:

6.3.1 Criminal consequences

The commission of an offence exposes the credit provider, certain officers of a corporate credit provider and persons or corporates who aided and abetted the commission of the offence to monetary penalties. The maximum penalty currently provided for in the Code is \$10,000.

6.3.2 Part 6 – Civil consequences

Key requirements: Division 1 of Part 6 sets up a regime under which, if a key requirement is breached, civil consequences may flow. Put simply, those civil consequences are that the debtor may not be required to pay any interest under the credit contract or the credit provider may be required to make a payment (of up to \$500,000 per type of breach) to consolidated revenue or into a statutory trust fund.

Other contraventions: Division 2 of Part 6 provides that a court may order the credit provider to make restitution or pay compensation to any person affected by a contravention, other than one for which a civil effect is specifically provided for in the Code.

6.3.3 General civil consequences

Other civil penalties are provided for in the Code. For example, a credit provider's failure to comply with certain requirements in connection with a mortgage or guarantee can result in the mortgage or guarantee (or certain provisions of such a document) being void or unenforceable.

6.3.4 Linked credit provider

Under the so called linked credit provider provisions of the Code, a credit provider can be held responsible for certain actions and statements made by a supplier of goods or services in connection with the credit contract and the sale contract, if there is a sufficient connection between the credit provider and that supplier.

6.3.5 Unjust contracts

Pursuant to the Code, a court or tribunal can reopen the transaction that gave rise to an unjust contract, mortgage or guarantee (or an unjust variation). It can also annul or reduce certain unconscionable fees.

6.4 The credit provider indemnified for a breach of the Code

In general, as a matter of public policy, the courts will not enforce a contract that provides for a person to be indemnified against criminal, and arguably, civil penalties under a statute.

This policy was of concern to trustees involved in securitisation programs and led to a submission by the Trustee Corporations Association of Australia (TCA) to State and Territory Consumer Affairs Ministers in relation to the impact of the Code on securitisation. Clayton Utz assisted the TCA in making that submission.

This concern has now been largely overcome by section 169A of the Code. That section provides as follows:

- "(1) An indemnity for any liability under this Code is not void, and cannot be declared void, on the grounds of public policy, despite any rule of law to the contrary.*
- (2) The liabilities to which this section applies include the following –*
- (a) a liability for any criminal or civil penalty incurred by any person under this Code;*
 - (b) a payment in settlement of a liability or alleged liability under this Code;*
 - (c) a liability under another indemnity for any liability under this Code.*

(3) This section is subject to section 169(2).

(4) This section does not derogate from any other rights and remedies that exist apart from this section.

(5) This section extends to any indemnity obtained before the commencement of this section."

This section provides that an indemnity from any person for any liability under the Code is not void on the grounds of public policy. Those liabilities are expressed to include both civil and criminal penalties, a payment in settlement of a liability or alleged liability under the Code, and a liability under another indemnity for any liability under the Code.

6.5 Licensing and registration requirements

The Administration legislation in Victoria, the Australian Capital Territory and Western Australia requires providers of credit which is regulated by the Consumer Credit Code to be either registered or licensed.

That legislation must be carefully reviewed to determine which of the parties involved in a securitisation program need to be so licensed or registered.

6.6 Conclusion

Where Code-regulated receivables are to be securitised, it is important, in light of the consequences of contravention, that these comply with the Code to ensure the integrity of the relevant program. For this reason it is current practice for a Code compliance sign-off to be received by selected participants (including the rating agency) from a major law firm involved with the securitisation.

The next sections of this publication deal with two matters principally affecting the participation by banks, building societies and credit unions in securitisation – the Australian Prudential Regulation Authority requirements (section 7) and set-off (section 8).

7 The regulation of the participation by authorised deposit-taking institutions in securitisations

7.1 Australian Prudential Regulation Authority guidelines

7.1.1 Introduction

The Australian Prudential Regulation Authority (APRA) is responsible for regulating, amongst others, authorised deposit-taking institutions (ADIs). The regulation of ADIs has the effect of bringing under APRA's authority Australian building societies and credit unions in addition to the Reserve Bank of Australia's (RBA) previous mandate to regulate Australian-owned banks, foreign subsidiary banks and branches of foreign banks.

APRA has powers under section 11AF of the *Banking Act 1959* to make prudential standards for ADIs and their holding companies.

APRA's Prudential Standard APS 120 – *Funds Management & Securitisation* (APS 120) became effective on 1 October 2000. APS 120 applies to the participation by ADIs in all capacities, both within Australia and overseas, in the securitisation of assets (whether or not the ADI is the sponsor).

Some of the principles in APS 120 are also intended to apply to foreign banks operating in Australia through branches. Whilst the capital adequacy treatment of their involvement is not regulated by APS 120, foreign banks are required to comply with its disclosure and separation provisions (which are dealt with below).

In APS 120, APRA warns that securitisation exposes an ADI to moral or commercial pressure to support a securitisation vehicle beyond its legal obligations. A fundamental principle underlying APS 120 is that ADIs must resist these pressures and only provide support to a securitisation vehicle strictly in accordance with their formal legal obligations.

Where the totality of an ADI's involvement in funds management and securitisation suggests that the overall level and/or concentration of risks has become excessive relative to its capital, APRA may require that ADI to maintain a buffer above the minimum capital ratio.

The approach of APS 120 is to concentrate on three aspects. The first is to attempt to minimise the moral or commercial pressures on an ADI by ensuring that there is sufficient separation between the ADI and a securitisation vehicle and for there to be adequate disclosure to investors of an ADI's limited role.

The second is to outline the requirements that need to be satisfied if an ADI provides facilities to a securitisation vehicle and to specify the capital that needs to be held against these.

The third is to set out the requirements that must be satisfied in order for an ADI to be relieved of the need to hold capital against assets transferred by it to a securitisation vehicle.

7.1.2 Separation and disclosure

APS 120 requires that an ADI must ensure that a securitisation vehicle should stand "clearly separate" from any ADI involved in the scheme. To achieve this, the vehicle should not include the words "bank, building society, credit union, authorised deposit taking institution or ADI" in its name. An ADI cannot have any ownership or beneficial interest in the vehicle, or control it for accounting purposes, and the ADI must limit the number of its directors on the board of the vehicle. In addition, the ADI should not itself act as manager or trustee of the vehicle (but can do this through a subsidiary which is not itself an ADI).

APS 120 also requires that any marketing materials (eg. an information memorandum) should not give the impression to investors that the vehicle is backed by the ADI beyond any legal obligations to which it has formally committed itself. In particular, investors should be unambiguously informed in writing that the securities do not represent deposits or other liabilities of the ADI, that the securities are subject to investment risk and that the ADI does not stand behind the capital value and/or performance of the securities issued by the vehicle. An information memorandum must display this prominently (generally as a stand-alone item on the inside front cover) and investors must sign an acknowledgement to this effect (except in some circumstances where the securities are electronically traded and it is impractical to obtain such an acknowledgement).

Where an ADI fails to comply with the foregoing, it must hold capital against the full value of the relevant securities. In addition, APRA warns that where investors are given the impression that the securities are backed by the ADI, it may be precluded entirely from engaging in securitisation activities.

One of the requirements for "separation" of securitisation entities under APS 120 is that the ADI should not "control" the entity such that it would need to be consolidated with the ADI for Australian accounting standards. This has caused much controversy in recent years as Australian accountants had historically taken a less demanding view of the relevant accounting standards than their European counterparts (although the wording of the standards in Australia and Europe was almost identical). The accounting firms had periodically tried to bring the Australian interpretation into line with that in Europe – only to back down each time in the face protest from their clients.

From 1 January 2005, however, Australia has adopted International Financial Reporting Standards (IFRS) and this has finally allowed the accounting firms to take a uniform view of transactions across jurisdictions. As a result, it is now more difficult for ADIs to comply with the separation requirements of APS 120 (and to a lesser extent the clean sale requirements discussed below).

However, APRA has stated that it will not be making any IFRS-related changes to its prudential standards before 1 July 2005 and until then the separation requirements (and clean sale requirements discussed below) should continue to be applied for the purposes of APS 120 based on the accounting standards in place as at 31 December 2004.

7.1.3 Provision of facilities by ADIs

APS 120 permits an ADI to provide various facilities and services to a securitisation vehicle without adverse capital consequences if certain requirements are satisfied. The treatment of this area is exhaustive and covers, for example, ADIs providing credit enhancements, liquidity facilities, underwriting commitments, advice to investors, the purchase of securities, the purchase (or repurchase) of assets from a securitisation vehicle, the provision of management and servicing functions and the entering into of derivatives with a securitisation vehicle.

Although the requirements differ depending on the type of facility or service to be provided, there are some broadly uniform preconditions.

In particular, a facility or service should be provided on an arm's length basis and on market terms and conditions and should be subject to the ADI's normal internal approval procedures. There should also be no recourse to the ADI beyond its fixed contractual obligations and the ADI should obtain a legal opinion to this effect.

The treatment by APS 120 of credit enhancements warrants particular comment. In this context, the relevant provisions apply not only to traditional credit enhancements but also include other types of facilities (eg. some liquidity facilities or where an ADI funds a spread or reserve account). APS 120 divides credit enhancements into two categories: a first loss facility and a second loss facility. As its name suggests, a first loss facility represents the first level of credit enhancement to a securitisation vehicle. Because of the greater risks associated with a first loss facility, an ADI providing this should, for capital adequacy purposes, deduct the full amount of the facility from its capital base, up to a maximum of the amount of capital that it would normally be required to hold against the full value of the

securities issued by the vehicle. On the other hand, a second loss facility can be treated as a normal credit facility for capital adequacy purposes. A second loss facility credit enhancement should be protected by a "substantial" first loss facility and should only be capable of being drawn after the first loss facility has been completely exhausted. In this context, "substantial" should be sufficient to cover a multiple of historical or worst case losses.

7.1.4 Transfer of assets

APS 120 sets down the conditions that must be satisfied if an ADI wishes to be relieved from the requirement to hold capital against assets it has sold to a securitisation vehicle. Significantly, APRA states that in supplying assets to a securitisation vehicle, ADIs should ensure that this will not lead to a deterioration in the average quality of assets remaining on its balance sheet.

In order to qualify, a transfer of assets must be a clean sale. APS 120 sets down a number of prerequisites for this to occur. In particular, the beneficial ownership of the assets must be transferred (although the ADI may retain legal ownership) and the risks and rewards of the assets must also be fully transferred to the vehicle. External audit and appropriately qualified internal or external legal opinions should be obtained confirming compliance with these and various additional requirements. In recognition of some structures, APS 120 permits an ADI to continue to receive surplus or excess income generated by securitised assets and, where the assets are revolving, to retain an interest in them, provided certain additional requirements are satisfied.

As noted above, the introduction of IFRS has made the derecognition tests set out in the Australian accounting standards more difficult to satisfy but APRA is still considering the implications of IFRS for APS 120 and until it does so APS 120 will continue to apply on the basis of accounting standards in place as at 31 December 2004.

7.1.5 APRA's new conglomerate capital adequacy regime

APRA introduced revised prudential standards for ADI conglomerates on 1 July 2003. Amongst the revised prudential standards is Prudential Standard APS 222 – *Associations with Related Entities* which can impact upon securitisation transactions in which an ADI provides funding to the securitisation vehicle. Under APS 222, an ADI's intra-group exposure is subject to certain limits prescribed by APRA. Such limits will not apply to an ADI's exposure to subsidiaries which form part of closely held companies that are part of the Extended Licensed Entity (ELE). Whether a subsidiary is eligible for

inclusion within the ELE depends on factors such as the ADI's extent of control over, and integration with the subsidiary as well as the existence of any third party liabilities of the subsidiary. Generally securitisation vehicles will not form part of the ELE and the ADI will be subject to limits on exposures to the vehicle under APS 222 if the vehicle is a related entity of the ADI.

7.2 The grant of collateral by Australian ADIs

When an ADI participates in securitisation structures, it is often a requirement of the rating agency that the ADI provides, or agrees that it will in the future provide, collateral in support of its obligations. This is particularly required where the ADI does not have the requisite rating commensurate with its role and the rating of the relevant securities.

The provision of collateral by Australian ADIs as security for their obligations is a problematic issue. The reason for this is section 13A(3) of the *Banking Act* which replaces the former section 16(1). This provides as follows:

"If an ADI becomes unable to meet its obligations or suspends payment, the assets of the ADI in Australia are to be available to meet that ADI's deposit liabilities in Australia in priority to all other liabilities of the ADI."

Section 13A(3) is often characterised as prohibiting Australian ADIs from granting security (or collateral). Strictly speaking this is not correct. An ADI can grant security, but to the extent that it is over the Australian assets of the ADI the effect of section 13A(3) is that the security (or collateral) is postponed behind the claims of the ADI's depositors.

Section 13A(3) therefore is more in the nature of a statutory first ranking security in favour of the ADI's depositors rather than a prohibition on the ADI granting securities to others. Nevertheless, it is the practice of Australian ADIs not to grant a security for the performance of their banking obligations.

Section 13A(3) poses difficulties in the context of a rating agency's requirement for an ADI to provide collateral. Clearly this cannot be in the form of a security in the legal sense. Instead, Australian securitisers have developed, in conjunction with the rating agency, alternative arrangements which replicate the economic (and legal) effects of a security, but which do not infringe the limitations imposed by section 13A(3). One particular method, which was developed by Clayton Utz, has been approved by APRA. This has been crucial to the development of the ADI-sponsored securitisation market in Australia.

7.3 Covered bonds

Covered bonds are full recourse debt instruments secured by a particular pool of assets. "Traditional" covered bonds are generally issued in certain European countries under specific enabling legislation eg. *Pfandbriefe* in Germany and *Obligation Foncière* in France. In July 2003, HBOS completed its first structured covered bond issue in the United Kingdom. The structured covered bonds issue by HBOS generated interest among Australian ADIs as a result of the lower costs of funding associated with such issues and the access that they give to wider and new investor bases.

Although APRA's current prudential standards do not prohibit ADIs from issuing covered bonds, APRA has taken the view that the issuance of covered bonds by ADIs would be inconsistent with Australia's depositor preference regime. Therefore, APRA will not allow the issuance of covered bonds (or structures with equivalent effect) by ADIs in Australia.

7.4 Basel II

As a general rule, APRA's prudential standards follow the current 1988 Basel Accord to the extent that it is applicable. The 1988 Basel Accord has since been revised and a new accord, Basel II, was published in June 2004 and is scheduled for implementation in 2007.

APRA will implement Basel II from 2007 and will issue draft prudential standards by early 2005. At the time of writing no draft prudential standards on Basel II have been issued by APRA. Among some of the changes for securitisation as result of Base II are:

- securitised instruments will no longer be 100 percent risk weighted but will be risk weighted dependent upon their external credit rating. This will encourage greater investment in securitised instruments by ADIs;
- the current zero percent risk weighting applied to liquidity facilities of less than one year will be modified, resulting in an increase in the cost of providing liquidity to conduit securitisation vehicles;
- the current 50 percent risk weighting that applies to residential mortgage lending will be reduced to 35 percent under the standardised Basel II approach thus reducing the regulatory capital requirements for certain ADIs. As such, there may be less incentive for ADIs to securitise their residential mortgages;

- ADIs that have securitised assets but retain a role that exposes them to operational risk will have to hold capital against such operational risk, despite the securitised assets having been taken off the balance sheet;
- in many cases the regulatory capital incentive for securitisation will be decreased as the risk weightings of assets held on the balance sheet are adjusted to more closely reflect the risks inherent in those assets.

Although the changes will remove some of the opportunities for regulatory capital arbitrage which have encouraged securitisation by ADIs, Basel II is expected to have, overall, a positive impact on the securitisation industry.

7.5 Conclusion

In Australia, most of the nation's securitisable assets are held by ADIs or their finance company subsidiaries. Accordingly, the approach of APRA to the securitisation of these has been, and will continue to be, critical to the development of securitisation in Australia. The current rules, as embodied in APS 120, are sympathetic to the process and have formed the basis of the recent expansion of the market into the securitisation of ADI-owned or controlled assets.

The next section of this publication examines another aspect which has been highlighted with the recent ADI securitisations, the role of set-off.

8 Set-off and securitisation

8.1 Introduction

A common type of securitisation in Australia involves an ADI selling (by way of an equitable assignment) a pool of its loans or other receivables to a special purpose vehicle (usually a trustee). Typically, the ADI remains as servicer of the loans and the ADI's customers are unaware of the assignment. Customers will only be given notice of the assignment if the special purpose vehicle perfects its title to the loans (ie. it takes a legal assignment of the loans).

Set-off is an important issue where ADIs securitise their assets. In particular, the issue is whether a customer, on its ADI becoming insolvent, can set off the amount standing to the credit of its deposit account(s) with the ADI against the customer's loan assigned by the ADI to the special purpose vehicle.

The rating agencies and investors are principally concerned with this issue. It is important that the special purpose vehicle's assets (ie. the assigned loans) are not detrimentally affected by (and are *insulated* from) the ADI's insolvency.

The following sections deal with the four types of set-off (statutory set-off, equitable set-off, contractual set-off and insolvency set-off), mutuality in set-off, contracting out of set-off and, in conclusion, the application of these principles to the resolution of this issue.

8.2 Statutory set-off

The statutory right of set-off is based upon the English Statutes of Set-Off of 1729 and 1735. These were incorporated into the law of the Australian States when they were established as British colonies. They have since been repealed in New South Wales and Queensland (although it is arguable that in Queensland the principles of statutory set-off still apply). In all other States, the Statutes of Set-Off remain in operation.

The statutory right of set-off is a defence to an action for payment of a debt owing by the defendant to the plaintiff. It enables the defendant to set off against the plaintiff's claim the indebtedness of the plaintiff to the defendant.

Statutory set-off only applies where both demands are liquidated and are due and payable before the date of the relevant action. The claims that we are considering here (ie. the customer's indebtedness to an ADI under its loan and the ADI's liability for the amount of the customer's deposit accounts in credit) would normally satisfy both of these requirements. The claims must also be mutual. Mutuality is discussed in section 8.6.

8.3 Equitable set-off

Equitable set-off was developed by the Courts of Equity to protect a party denied statutory set-off where this would result in an injustice or an inequitable result. The classes of equitable set-off are not closed and there are some differences between the approach adopted by the courts in England and Australia. However a prerequisite for the application of equitable set-off is normally that either:

- the claim and the cross-claim arise out of the same transaction; or
- the claim and cross-claim arise out of transactions that are inseparably connected.

It appears (although the authorities diverge on this point) that the courts may also require that the cross-claim must impeach the claim. That is, it may not be sufficient that the claim and the cross-claim arise out of the same or inseparably connected transactions, but rather the cross-claim must in some way undermine the very basis of the claim.

In addition, an equitable set-off may be denied by the courts even where these tests have been satisfied, if in the circumstances, it would be unjust or inequitable to allow a set-off to occur.

There have been mixed results in cases where equitable set-off has been claimed in defence to the enforcement of a mortgage loan.

In some cases the courts have protected the mortgagee's right to repayment of the mortgage debt free of set-off. In other cases the courts have permitted a customer to set off its mortgage debt against damages for breach of contract where (in one case) the breach rendered the customer unable to repay the mortgage debt and (in another case) the claim for damages far exceeded the mortgage debt. It is conceivable that a default by an ADI on a deposit account could produce a similar result to either of these fact situations. An equitable set-off of a deposit account against a mortgage loan might be available, for instance, in the following circumstances:

- an ADI may offer to customers the ability to offset the interest liability on their mortgage loan against the interest earned on a nominated deposit account. Such an account could be construed as inseparably connected with the corresponding mortgage loan from the ADI; or

- an ADI's default in respect of a customer's deposit may result in the customer defaulting on its mortgage loan. In this situation, the mortgage loan and the deposit could be regarded as so closely connected that it would be unjust not to allow the customer to set off the deposit against the mortgage loan.

Generally speaking, the more closely the contracts under which the claims arise are related, the more likely it will be that an equity will arise to allow a set-off.

8.4 Contractual set-off

Two parties can enter into an agreement to set off their respective liabilities to each other so that there is only, as between them, a single liability for the balance. Contractual set-off takes effect according to its terms and is enforceable until one of the parties to the agreement becomes bankrupt or insolvent.

In the context of the relationship between an ADI and one of its customers, contractual set-off will only apply if there is an agreement to this effect in the documents regulating the rights between them. It is usual that the documentation in relation to a mortgage loan will provide the ADI with a right to combine the accounts of the customer. The correct classification of such a combination of accounts clause is that it is a form of contractual set-off.

8.5 Insolvency set-off

Insolvency set-off arises where one of the claimants is insolvent or bankrupt. Insolvency set-off is governed by statute (section 86 of the *Bankruptcy Act* 1966 for individuals and section 553C of the *Corporations Act* for companies).

The two sections are identical and provide that where there have been mutual credits, mutual debts or other mutual dealings (see section 8.6) between the bankrupt (or insolvent) person and a person claiming a debt in the bankruptcy (or insolvency):

- "(a) an account will be taken of what is due from one party to the other in respect of those mutual dealings;*
- (b) the sum due from one party must be set off against any sum due from the other party; and*
- (c) only the balance of the account may be claimed or is payable."*

Insolvency set-off, when it applies, is mandatory and applies to the exclusion of statutory, equitable and contractual set-off. Unlike other forms of set-off it cannot be excluded by agreement between the parties (see section 8.7).

8.6 Mutuality

For statutory set-off or insolvency set-off to be permitted there must be mutuality. The general principle underlying mutuality is that the claim of one person should not, without agreement, be used to satisfy the liability of another ie. "one man's money shall not be applied to pay another man's debt" (*Jones v Mossop* (1844) 3 Hare 568).

For there to be mutuality, each claimant must be the beneficial owner of the claim owed to it. Generally, set-off will not be available if the claims are legally mutual, but not equitably mutual. For example, a debt due to a party in its own right cannot be set off against a sum owed by the party in its capacity as trustee.

In the securitisation of loans outlined above, and prior to perfection of title, the ADI is the legal owner of the sold loans, but the special purpose vehicle is the owner in equity. After perfection of title, the ADI will be neither the legal nor equitable owner of the sold loans.

The mutuality principle therefore, on its face, seems to prevent statutory or insolvency set-off by the customer -as a result of the change in equitable ownership of the loan. Generally the time for determining mutuality is when the set-off is being asserted (or, for insolvency set-off, as at the commencement of the insolvency). The most important variation from this principle is in the context of the assignment of a debt (which is relevant here). Where there is an assignment of a primary debt, the assignee takes subject to the equities. This means, in the situation under discussion, that the special purpose vehicle takes a sold loan subject to the right of the customer to assert against the special purpose vehicle the same set-off rights that it could have asserted against the ADI. However, once the customer receives notice of the assignment, this crystallises the equities and the customer cannot thereafter set up as against the special purpose vehicle any new and independent equities which subsequently arise (subject to some exceptions which are not relevant here). In practice, this means that once the customer is advised of the assignment of its loan it will not be able to claim a set-off for any new deposits that it makes with the ADI (but will retain its rights in relation to any existing deposits).

However, this result and the principle that an assignee takes subject to the equities, does not apply if the customer agrees otherwise. Often, loan documentation explicitly states that the ADI may assign the loan free of all equities. A provision of this type is effective subject to the matters discussed in section 8.7.

The absence of mutuality is relevant only for statutory and insolvency set off. Strictly speaking, mutuality is not an essential ingredient for contractual set-off. There is no principle of law preventing A, B and C agreeing that A's liability to B can be set off against B's liability to C.

Mutuality also is not strictly essential for equitable set-off (but in most circumstances mutuality will effectively be required as it will usually be inequitable to apply one person's rights against another's debts).

8.7 Contractual exclusion of set-off

Both statutory set-off and equitable set-off can be excluded by an express contractual provision to this effect.

In some early English cases it was held that statutory set-off could not be excluded by agreement. These cases are no longer good law. This was confirmed by the English Court of Appeal in *Coca-Cola Financial Corporation v Finstat International Ltd* [1996] 3 WLR 849 (and, effectively, by the House of Lords in refusing leave to appeal the decision in this case). There have also been a number of Australian cases that confirm that statutory set-off may be excluded by agreement.

Contractual set-off is purely a creature of contract and will apply to the extent agreed.

In contrast to other forms of set-off, insolvency set-off is mandatory and may not be excluded by contract. Further, in the case of loans governed by the Consumer Credit Code (which includes all owner occupied mortgage loans originated after 1 November 1996), the stated principles are subject to the application of section 166 of the Code. Section 166(2) provides that a "debtor, mortgagor or guarantor has and may exercise the same rights in respect of [a] credit contract, mortgage or guarantee against the assignee [of the credit contract, mortgage or guarantee] as the debtor, mortgagor or guarantor has against the credit provider."

The operation of the Code cannot be excluded by contract.

It is not clear that section 166(2) applies to rights of set-off. Nevertheless section 166 throws doubt upon the operation of provisions in loans governed by the Code that allow the loan to be assigned by the ADI free of any equities. The section does not

have any impact on clauses in a loan that provide for payments to be made by a customer free of set-off, deduction or counterclaim as such clauses apply equally to the original credit provider and an assignee.

8.8 Customer's ability to set-off against an insolvent ADI

For practical purposes a customer's rights to set-off will only be relevant upon the insolvency of the ADI. If a customer exercises a right of set-off prior to the ADI's insolvency, the agreement between the special purpose vehicle and the ADI will usually provide that the ADI must compensate the special purpose vehicle for, or make payments to the special purpose vehicle clear of, amounts set-off by the customer.

If the ADI becomes insolvent, the special purpose vehicle will then immediately perfect its title to the assigned loans. In these circumstances the customer will be endeavouring to set-off in respect of its obligations to the special purpose vehicle under its ADI loan and the insolvent ADI's obligations to it in respect of deposit accounts. Applying the rules of set-off discussed above leads to the following conclusions:

Statutory set-off

When the customer's loan is assigned in equity to a special purpose vehicle the customer will lose any rights of statutory set-off that it may have in relation to the loan and a deposit account held with the ADI. This is because there will no longer be any mutuality between the beneficial interests in respect of the ADI's rights under the loan and obligations under the deposit account. Also, a customer will be bound by any provision in the loan or deposit account documentation that excludes the customer's rights of statutory set-off or (subject to the possible application of section 166 of the Consumer Credit Code) allows the ADI to assign the mortgage loan free of such rights.

Equitable set-off

In certain circumstances, a customer may have a right of equitable set-off against its loan in respect of a deposit account held by the customer with the ADI. This may be the case notwithstanding the lack of mutuality of beneficial or legal interests with respect to the loan and that deposit account. However, the customer will not have any right of set-off in respect of deposits made after the customer becomes aware of the assignment of the loan. Further, this result is subject to any provision in the mortgage loan or deposit account documentation that excludes the customer's rights of equitable set-off or (subject to the possible application of section 166 of the Consumer Credit Code) allows the ADI to assign the mortgage loan free of such rights.

Contractual set-off

A customer will only have a contractual right of set-off if this is provided in the relevant loan or deposit account documentation. In our experience this is rarely the case.

Insolvency set-off

Insolvency set-off will only be relevant in these circumstances upon the insolvency of the customer or the ADI. In either case the other forms of set-off will cease to apply and, since there will be no mutuality between the customer's rights under the deposit account (against the ADI) and its obligations under the loan (to the special purpose vehicle) at the time of the insolvency, insolvency set-off will not be permitted.

8.9 Conclusion

In the early days of securitisations by ADIs in Australia, there was considerable concern that set-off could lead to the result that a special purpose vehicle's assets were not insulated from the ADI's insolvency. As the industry worked through the complex rules regarding set-off it became clear that this is not the case where the underlying loan documents contain a waiver by the borrower of its set-off rights. This conclusion is particularly important as it enables securitisations by ADIs to proceed in Australia without the necessity for reserves to be established to compensate for any set-off risk.

9 Insolvency and securitisation

9.1 Introduction

In securitisations in Australia, issuers are either special purpose companies acting in their own right or trustee companies acting as the trustee of a trust.

In both cases the effect of the insolvency of the issuer on the securitisation program is crucial to an assessment of the risk for investors who acquire the program's securities.

In the case of a corporate issuer, the rating agencies need to be confident that the assets of the company will be distributed upon its insolvency in the manner intended by the underlying transaction documents.

Where the issuer is acting as the trustee of a trust two possible insolvencies are relevant – the insolvency of the trust and the insolvency of the trustee. If the trust is insolvent the same question arises – that is, will the assets of the trust be distributed in the manner intended by the underlying transaction documents? If the trustee, but not the trust, is insolvent it is important that the insolvency of the trustee has a minimal impact on the operation of the trust and on payments under the relevant securities. In particular, it must be possible to replace the trustee and ensure that the assets of the trust are not available to the general creditors of the insolvent trustee.

The following sections consider the principles governing insolvent companies, trusts and trustees; the position of secured creditors; the types of transactions which may be void or voidable due to insolvency; and some special insolvency issues relating to segregated issuers. The final section considers the requirements of the rating agencies in light of these issues.

Set-off is also relevant in insolvency and this is discussed in section 8 of this publication.

9.2 Insolvent companies

9.2.1 Definition of insolvent

Section 95A of the *Corporations Act* provides that "a person is solvent if, and only if, the person is able to pay all the person's debts, as and when they become due and payable" and goes on to state that "a person who is not solvent is insolvent."

If a company is insolvent a court may order that it be wound up upon the application of any of a number of persons including the company, a director of the company or a creditor of the company (even if the creditor is a secured creditor or is only a contingent or prospective creditor).

The courts have considered the definition of insolvency (which was based on provisions in the previous Companies Code and case law) on many occasions. For present purposes the following should be noted:

- in order for a company to be solvent it must be able to pay its debts as and when they become due and payable. So, for instance, if a company's assets significantly outweigh its liabilities but these assets are illiquid and are unable to be utilised to meet these liabilities as they fall due, the company will nevertheless be insolvent;
- however, a temporary lack of liquidity should not be equated with insolvency. It is necessary to consider not only the company's cash on hand, but also the moneys that it can procure by realisation by sale or by mortgage or pledge of its assets within a relatively short time; and
- insolvency may be established by a company failing to comply with, or dispute, within 21 days, a statutory demand served on the company by a creditor.

9.2.2 The role of a liquidator

A liquidator appointed upon a company's insolvency must realise the property of the company and apply it in accordance with the provisions of the *Corporations Act*. Except as otherwise provided by the *Corporations Act*, all claims against the company proved in its winding-up rank equally and if the property of the company is insufficient to meet such claims in full they must be paid proportionally. There are two important qualifications to the operation of this principle. The first is that an unsecured creditor can agree to be subordinated to other creditors of the company (section 563C). The second qualification is that the statutory order does not apply to secured creditors to the extent that they do not participate in the winding-up and instead rely on their securities.

The following is a general summary of the order of payment of claims as affected by the *Corporations Act*.

- (a) claims which are secured to the extent that they may be met by realisation of the property subject to the security (unless the security is a floating charge);
- (b) certain claims that have priority over creditors who are secured by a floating charge to the extent that they may be met by realisation of the property subject to the floating charge (and will not be met under (g)). In summary these are:
 - certain claims in respect of wages, superannuation, leave of absence and retrenchment payments due to employees of the company;

- claims in respect of moneys advanced by a person to the company for the purposes set out in the previous paragraph; and
 - certain auditor’s fees.
- (c) claims secured by a floating charge to the extent that they may be paid by realisation of the property subject to the floating charge;
- (d) claims in respect of which the company has received insurance proceeds to the extent of those proceeds;
- (e) certain costs in the winding-up and administration of the company;
- (f) certain claims by employees or in respect of injury compensation which were not paid under items (b) and (d); and
- (g) claims of all creditors proportionally in relation to the amount of their claim.

9.2.3 The role of an administrator

The provisions in the *Corporations Act* in relation to the appointment of administrators to companies are also relevant in respect of the insolvency of a special purpose corporation. These provisions allow an administrator to be appointed to a company for a period of 28 days (or 35 days over the Christmas or Easter periods). The administrator takes control of the company’s affairs and investigates whether it is in the interests of creditors of the company to enter into a deed of company arrangement to overcome the company’s financial difficulties.

An administrator may be appointed by the company, a liquidator or a provisional liquidator of the company or a chargee who is entitled to enforce a charge over the whole, or substantially the whole, of the company’s property.

For present purposes the following two aspects of administration are significant:

- During the period of the administration, a proceeding in a court against the company or in relation to any of its property cannot be begun or proceeded with, the owner or lessor of property that is used or occupied by or is in the possession of the company cannot take possession of the property or otherwise recover it, no enforcement process in relation to the property of the company can be begun or proceeded with and a person cannot enforce a charge on the property of the company except, in each case, with the administrator’s written consent or with the leave of a court.

- Despite the rules in the previous paragraph, a chargee which has a charge over the whole, or substantially the whole, of the property of the company may enforce the charge in relation to all property subject to the charge provided that it does so within 10 business days of the date that the chargee receives notice of the appointment of the administrator.

9.3 Insolvent trusts and trustees

Where an issuer in a securitisation program is the trustee of a trust, the insolvency of the trust and that of the trustee must be distinguished.

9.3.1 Insolvency of the trust

Strictly speaking a trust cannot be insolvent. This is because trusts do not have any legal capacity. A trust cannot sue or be sued and neither can it have a liquidator or administrator appointed to it.

When a trust is said to incur a liability (for instance, when a bond is issued by a trustee in a securitisation program) the following in fact occurs:

- the trustee itself incurs the liability;
- the trustee by virtue of incurring the liability, provided that it was incurred for the purposes of the trust and in accordance with the provisions of the relevant trust deed, will be entitled to be indemnified from the assets of the trust against the liability and will have a lien over the assets of the trust to secure its rights under the indemnity; and
- unless otherwise agreed, the trustee must meet its liabilities with respect to the trust from its own assets if its indemnity from the assets of trust is insufficient.

In securitisation programs which have trustee issuers, the obligations of the trustee to investors and other creditors will invariably be limited to the assets of the trust out of which the trustee is indemnified for the liability (in the absence of fraud, negligence or wilful default on the part of the trustee). However this limitation does not affect the nature of the liability. The liability is the trustee’s liability – albeit one which is limited by reference to the trustee’s indemnity from the assets of the trust.

Thus, a reference to a trust being insolvent is really a shorthand way of saying that the obligations which the trustee has properly incurred as trustee of the trust cannot be met from the proceeds of the trustee’s indemnity from the assets of the trust. The consequences of this include:

- if the trustee has not limited its liability, the trustee must meet those obligations from its own assets and, if it is unable to do so, the trustee will itself be insolvent;
- if the trustee has limited its liability in the manner described above, the trustee's liability in respect of the obligations will be reduced to the amount available to meet those obligations from the assets of the trust and neither the trust nor the trustee will be insolvent; and
- the directors of the trustee will need to consider the possibility of being called upon to meet the shortfall. This is discussed in the next section of this publication.

However, in the circumstances described in the second point above, and notwithstanding that the trustee's liability has been reduced, the trustee's failure to meet the obligations in full may have other consequences, such as the accelerated repayment of principal to investors and the triggering of the enforcement of security given by the trustee.

9.3.2 Insolvency of trustee

If the liability of the trustee issuer has been properly limited in a securitisation program, then losses or liabilities incurred in respect of the trust should not cause the trustee to be personally liable or at risk of becoming insolvent. An exception to this will be if the losses or liabilities were incurred due to a failure by the trustee to properly perform its duties as trustee. If these losses or liabilities were sufficiently large they could cause the trustee to become insolvent. Also, a trustee could become insolvent as a result of being unable to meet liabilities unconnected with the trust or the securitisation program. Typically, trustee companies who act as issuers in securitisation programs are also trustees of many other trusts. A failure by the trustee company to perform its obligations in relation to any of these other trusts could lead to the trustee company incurring personal liability and, conceivably, to the insolvency of the trustee company.

In general, however, the insolvency of the issuing trustee does not present a serious risk to securitisation programs. This is because:

- the assets of the trust will not be available to meet the trustee's obligations to its general creditors or the creditors of any other trust; the trustee will only be entitled to be indemnified from the assets of the trust for liabilities incurred with respect to the trust; and
- the trust deed will invariably provide for the trustee to be replaced upon its insolvency and for all the assets of the trust to vest in a new trustee (usually appointed by the manager of the securitisation program).

9.4 Secured obligations

As can be seen from the general order of priority that applies under the *Corporations Act* (as set out in section 9.2) in the absence of any security for investors upon the insolvency of a corporate issuer, claims of the investors will be satisfied after various preferred claims (such as claims by employees and the costs of administrators and liquidators) and proportionally with the claims of all other unsecured creditors.

The same is not the case in relation to claims by investors against trust issuers. As discussed above, a trust cannot strictly speaking become insolvent. In the event that the assets of the trust are not sufficient to meet the liabilities incurred by the trustee in relation to the trust:

- the documentation giving rise to the liabilities will provide that the liabilities will be reduced, usually to the extent of the trustee's indemnity in respect of the liabilities (and if this is not the case the trustee will be personally liable); and
- the trust deed will usually provide an order of priority in which the liabilities are to be met.

However, for both corporate and trust issuers, it is invariably the case that investors have the benefit of security from the issuer (usually shared with other creditors such as liquidity facility and swap providers).

The security is usually a charge over all of the assets of the company (in the case of a corporate issuer) or all the assets of the trust (in the case of a trustee issuer) in favour of a security trustee. In the case of a corporate issuer, it should be noted that one of the effects of the charge being over all the assets of the company is that it may be enforced notwithstanding an administrator being appointed to the company.

The charge will often be a floating charge over all or some of the assets. This is because the courts will not recognise a fixed charge over assets that the chargor (the issuer) is entitled to deal with in the ordinary course of its business. In the case of certain securitised assets it would be impractical to have a fixed charge because of the need for ongoing dealings with the assets. Mortgage loans (the most commonly securitised asset in Australia) must, for instance, allow for variations, redraws and substitutions of the security property in order to satisfy consumer demand.

To the extent that the charge is a floating charge, certain claims of preferred creditors (such as employees) will take priority over the charge as set out above. In order to minimise the risk of this occurring, the rating agencies which rate securities will normally require that the issuer is restricted from engaging in activities (such as having employees) which could give rise to preferred claims (this is discussed in section 9.7).

9.5 Transactions void or voidable due to insolvency

Under Part 5.7B of the *Corporations Act*, certain transactions may be void or voidable upon the winding up of a company.

These provisions will be relevant in a securitisation program upon the winding-up of: the issuer; any seller of assets to the issuer; or any other person who provides rights to the issuer as part of the program (such as a liquidity facility or swap provider). Although the whole of Part 5.7B must be considered in relation to a securitisation program, the provisions most likely to be of concern are those relating to unfair loans and uncommercial transactions.

9.5.1 Unfair loans

A transaction may be set aside under Part 5.7B of the *Corporations Act* if it is an unfair loan within the meaning of section 588FD(1).

A loan will only be unfair if either the interest or charges payable in respect of the loan are “*extortionate*” or become “*extortionate*” as a result of a variation. There have been no reported decisions of the courts that have considered the meaning of the term “*extortionate*”. It is usually the case, however, that interest rates on bonds issued, or on funds borrowed under a liquidity facility, in a securitisation program are determined with reference to prevailing market rates. It is unlikely that interest rates determined in this manner would be regarded by the courts as extortionate.

9.5.2 Uncommercial transactions

A transaction may be set aside under Part 5.7B of the *Corporations Act* if it is an uncommercial transaction within the meaning of section 588FB(1) and is also an insolvent transaction within the meaning of section 588FC.

A transaction is an uncommercial transaction of the company:

“if, and only if, it may be expected that a reasonable person in the company’s circumstances would not have entered into the transaction, having regard to:

(a) the benefits (if any) to the company of entering into the transaction; and

(b) the detriment to the company of entering into the transaction; and

(c) the respective benefits to other parties to the transaction of entering into it; and

(d) any other relevant matter.”

A transaction of the company is an insolvent transaction:

“if, and only if, it is ... an uncommercial transaction of the company, and:

(a) any of the following happens at a time when the company is insolvent:

(i) the transaction is entered into; or

(ii) an act is done, or an omission is made, for the purpose of giving effect to the transaction; or

(b) the company becomes insolvent because of, or because of matters including:

(i) entering into the transaction; or

(ii) a person doing an act, or making an omission, for the purpose of giving effect to the transaction.”

As noted above, in addition to being relevant upon the insolvency of the issuer, these provisions may apply in the event of the insolvency of other parties involved in the program (such as the seller of assets to the issuer or liquidity facility or swap providers). This could result in the sale of such assets being set aside by a court.

However, even if a transaction is an uncommercial transaction and an insolvent transaction, section 588FG(2) prevents a court from making an order:

“... materially prejudicing a right or interest of a person if the transaction is not an unfair loan to the company and it is proved that:

(a) the person became a party to the transaction in good faith; and

(b) at the time when the person became such a party;

(i) the person had no reasonable grounds for suspecting that the company was insolvent at that time or would become insolvent ...; and

(ii) a reasonable person in the person’s circumstances would have had no such grounds for suspecting; and

(c) the person has provided valuable consideration under the transaction or has changed his, her or its position in reliance on the transaction.”

Section 588FG provides a measure of protection to investors against the subsequent winding-up of any party to a transaction in a securitisation program. However, the rating agencies are nevertheless concerned to ensure that the transactions in a securitisation program are commercial and, in particular, that any sale of assets to the issuer is a true sale for full value (as discussed below).

9.6 Segregated issuers

Segregated issuers are issuers who are able to issue separate series of securities which are backed by different assets and which are rated independently by the rating agencies (and which may have different ratings). In order to be considered a segregated issuer by the rating agencies it is necessary, amongst other things, that:

- a default by the issuer in respect of one series and enforcement of the security must not of itself cause a default or enforcement of security in respect of another series;
- creditors in respect of one series must not have access to the assets held in relation to any other series; and
- there must be only a very remote likelihood of the issuer being wound up during the program. This must be the case notwithstanding that in a winding up of the issuer, investors of a series will retain their rights in relation to the relevant securitised assets of that series. This is because the winding-up of the issuer will inevitably require the enforcement of the security held for all series and a resulting early termination of the program.

Segregation criteria are relatively easy to satisfy in relation to trust issuers. Segregation is achieved simply by creating a new trust for each segregated series.

Segregation for corporate issuers, however, is more difficult to achieve. It can be done effectively by:

- creating separate security over different assets for each series;
- limiting the default provisions in the documentation for each series to defaults by the issuer in relation to that series or events that occur in relation to the assets of that series;
- limiting the rights of each person who enters into a transaction with the issuer in relation to a series (including investors) to their share of the proceeds of realisation of the assets of that series upon enforcement of the security for that series; and

- limiting the rights of the issuer so that the issuer is unable to do anything other than act as the issuer in the securitisation program and, in particular, is not permitted to incur any liability other than a liability which is limited as described in the previous paragraph.

9.7 Rating agencies criteria

The rating agencies impose a number of restrictions and requirements upon issuers as a condition of rating their securities in order to minimise the risk to investors of the insolvency or winding-up of the issuer or of any other party to the transactions that make up the securitisation program. The following is a summary of the most significant of these and the reasons for their imposition.

9.7.1 Commercial sale of assets

Where the securitised assets are not originally the assets of the issuer, the issuer must acquire the assets in a transaction which is not, from the point of view of either party, an uncommercial transaction. A failure to acquire assets for the proper value could result in the purchase being set aside under Part 5.7B of the *Corporations Act* (as discussed above).

9.7.2 No mixing of assets

Where the issuer is a trust issuer, it is important that the assets of the trust are distinguishable from, and are not mixed with, any other assets of the issuer or the assets of any other trust of which the issuer is trustee. If assets are mixed they may lose their characterisation as property of the trust and consequently their protection from claims by any general creditors of the trustee. Where the issuer is a corporate issuer, issuing segregated series of securities, the assets backing each series must similarly be kept separate so that the security for one series may be enforced without impacting on the continued operation of another series.

9.7.3 Limited powers of issuers

By limiting the powers of trust issuers it is possible to limit the potential for creditors to exist who have access, through subrogation to the trustee's right of indemnity, to the assets of the trust. So, for instance, if a trustee is prohibited by the terms of the trust deed from engaging employees in its capacity as trustee then if, in breach of the trust deed, the trustee purports to engage employees in its capacity as trustee neither the trustee nor those employees through it will be entitled to be indemnified from the trust assets against the costs of the employment.

In segregated issues a similar result is aimed for by way of limiting the powers of the corporate issuer in its constitution. However, such limitations are not as effective as the equivalent restrictions in the trust deed of a trust issuer. This is because persons are entitled to assume that the company is acting within its powers unless they knew or suspected that this is not the case (sections 128 and 129 of the *Corporations Act*).

9.7.4 Tax liability

An unexpected liability for tax constitutes a risk for both corporate and trust issuers, as this may trigger the enforcement of the security in a securitisation program. This is because the tax authorities will never be subject to the limited recourse provisions, the transactions in a securitisation program involve dealings in large amounts of money and tax law is both highly complex and continually changing.

There is little risk that a liability of an issuer for tax could take priority over a liability to investors or other secured creditors. The Federal Commissioner of Taxation is an unsecured creditor in a winding-up of a company. It is possible for the Commissioner to effectively take priority over a floating charge by issuing a notice to a third party debtor of a taxpayer to pay amounts due to the taxpayer directly to the Commissioner. However, automatic crystallisation clauses in floating charges effectively preserve the priority of the chargee in such circumstances.

Nevertheless, an unexpected tax liability of an issuer can cause the issuer to become insolvent and make it necessary to enforce the security held for the investors and other secured creditors and thus result in the early termination of a program. Where the issuer is a trust issuer, the tax liability is likely to be limited to the particular trust and will thus only trigger enforcement of the security over the assets of that trust. Where the issuer is a segregated corporate issuer, however, the tax liability is a personal liability of the issuer and may require the enforcement of the security for all of the segregated series of securities issued by the issuer.

It is consequently important for all issuers, but in particular segregated corporate issuers, that the taxation consequences of the securitisation program have been carefully considered and that the issuer will either have no tax liability or that there will be sufficient funds to meet any tax liability. A legal opinion as to the liability to taxation of the issuer is invariably a requirement of the rating agencies.

9.7.5 Limited recourse of creditors

Finally, as discussed above, it is essential that all creditors of a segregated corporate issuer have agreed to limit the liability of the issuer to them to the amounts which they are entitled to receive upon enforcement of the security for the relevant series. A failure to properly limit the liability of a creditor will not result in the assets of other series being available to that creditor. It may, however, require the enforcement of the security for those series in order to protect the assets of those series from that creditor.

From the rating agencies point of view, limiting the recourse of creditors of trustee issuers is not such a significant issue since the insolvency of the trustee should not of itself result in the termination of a securitisation program. However, it is naturally a significant issue from the trustee's perspective and the rights of creditors against trust issuers are invariably limited as described above.

9.8 Conclusion

To date in Australia, there has not been a failure of a securitisation vehicle (although one or two have experienced difficulties, none have been placed under the external administration of a receiver or a liquidator). Nevertheless, the structuring of securitisation programs is very much influenced by the insolvency provisions of the *Corporations Act*. A rating of a securitised instrument, if it says nothing else, indicates that the securitised assets will be dealt with upon the insolvency of the issuer as intended by the underlying transaction documents.

The next section of this publication considers a number of issues that arise when debt securities are issued by trustees.

10 Issues relating to debt securities issued by trustees

10.1 Introduction

As indicated in Section 1, many securitisations in Australia proceed by way of the relevant assets being held in a trust with the trustee issuing debt securities. The use of trusts in this role raises a number of legal issues. These include the following which are reviewed in this section:

- the role and function of security trust deeds in these circumstances;
- the nature of the trustee's liability on its debt securities;
- the trustee's right of indemnification;
- whether trustees can issue promissory notes; and
- the effect at law if the trustee purchases debt securities issued by it in a different capacity.

10.2 Security trust deeds to secure trustee debt securities

10.2.1 Background

If a trustee issues equity securities, the obligations under these cannot be secured by a charge over the trust's assets in favour of a security trustee. The reason for this is that equity, by its nature, cannot be the subject of a security. However, when a trustee issues debt securities, the rating agency requires this.

Given that debt always ranks in priority to equity on a winding-up, this raises the issue of the relevance of security trust deeds for trustee debt securities. If they are not required for equity, why are they necessary for higher ranking debt securities?

The response of the rating agency to this question has been twofold. The first response is that this is consistent with their usual (though not uniform) requirements for debt securities issued by corporations. This though does not really answer the question. The second response is that a security trust deed is necessary to overcome perceived shortcomings with the trustee's right of indemnification from trust assets to meet liabilities on the debt securities. This second explanation is much more cogent and the legal basis for it is explained in the next section. (There is also a third response, which comes from lawyers, that security trust deeds are necessary for the enforceability of trustee debt securities: see section 1.3.3.)

10.2.2 The nature of the trustee's liability under its debt securities

It is a fundamental legal principle that obligations, such as owed under a debt security, can only be incurred by an entity recognised by the law as having legal existence. Such entities include individuals, corporations or a combination of the

foregoing in partnership. A trust, on the other hand, is not a separate legal entity. Rather, the term "trust" describes the basis upon which a person holds property.

When a trustee issues a debt security, it is not the trust itself that is liable to meet the obligations under this. Instead, it is the trustee that is liable for the debt security as if it had issued it personally.

The result is that when a trustee of a securitisation trust issues a debt security, at law the trustee is personally liable on the security. It is the party to whom an investor has recourse and may sue if there is a default (subject to any limitations on liability applying to that debt security, which is considered in section 10.3).

A trustee, however, is not expected to bear the liabilities of its trust without compensation. It has a right of recoupment against the trust assets for properly incurred trust liabilities.

This right of recoupment springs from three sources: the general law, statute (the *Trustee Acts*) and usually the relevant trust deed.

10.2.3 Shortcomings with the trustee's right of indemnification

The right of a trustee for indemnification from the trust assets is subject to an important limitation. The actual quantum of the right is not calculated simply on the amount of the properly incurred trust debts. Instead, it is determined after taking into consideration all of the trustee's liabilities to the trust for other matters. Thus, if the trustee commits a breach of trust so that it is personally liable to recoup the trust for this, the indemnity in respect of the properly incurred trust debts is accordingly reduced. In other words, a running account exists between what is due by way of compensation to the trust for breaches of trust by the trustee and what is due to the trustee by way of its indemnity for properly incurred trust debts. Only if that balance is in favour of the trustee can it recover from the trust and then only to the extent of that balance.

This has led to a concern, articulated particularly by the rating agency, that if the trustee properly issues unsecured debt securities (with its liability limited thereunder to the trust assets), but subsequently engages in an unrelated breach of trust, the trustee may not be entitled to recourse to the trust assets to meet the amount payable on the debt securities.

This then could lead holders of the debt securities to incur a loss, even though there are trust assets available to meet the amount due on their debt securities.

Two different solutions to this problem have been suggested.

These are:

The use of a security trust deed

The first approach treats the problem as stemming from investors being unsecured creditors of the trust and needing to rely on the trustee's right of indemnity in order to have recourse to the trust assets. The solution, therefore, is to elevate investors from unsecured to secured status. Under this approach, the trustee charges the trust assets as security for the debt securities and this charge is held for investors by a security trustee (almost always a company within the same group as the first trustee). In this way, investors do not need to be concerned about the state of the trustee's right of indemnity. Instead, they have a direct security interest (through the security trustee) over the trust assets for the full amount owed to them by the trustee. If the trustee's right of indemnity is in some way diminished, investors can still have recourse to the trust assets through the charge to meet the amount owing to them.

Enhance the contractual right of indemnity

The second approach is to strengthen the trustee's right of indemnity in the trust deed to make it clear that it will not be affected by unrelated breaches of trust by the trustee. The advantage of this approach is that it is simple and does not require an appointment of a security trustee. However, there are real reservations whether at law it is possible to achieve this result. Accordingly, for the time being, until the efficacy of the second alternative is clarified (by case law or statute), the general market approach is to use the first of the two solutions (ie. security trust deeds) to overcome the perceived problem for unsecured trust creditors with the trustee's right of indemnity. While this alternative involves increased cost (ie. the preparation of a security trust deed and the appointment for the time being of a security trustee), it has greater legal integrity than the second solution. This explains, therefore, the reason why all trust securitisations in Australia are accompanied by a security trust deed.

10.3 Limitations on the trustee's liability

One of the results of the analysis in section 10.2.2 is that where a trustee issues debt securities, its personal assets can be exposed to the claims of investors. However, a trustee can avoid this result if the investors agree to this. This is the basis of the limitation of liability clause that is inevitably found in trust securitisation structures. Usually, there are three elements to this:

Trustee does not issue debt securities personally

Typically, a clause will be found stating that the trustee does not issue the debt securities personally but only in its capacity as trustee. Strictly speaking, this statement does not correctly reflect the legal position for it is clear that the trustee is personally liable on the debt securities (see section 10.2.2).

However, it is probably best to approach these words not from a strict legal perspective but instead as describing in a general sense the trustee's role in issuing the debt securities. However, sometimes a variation on these words is found in the trust deed. It is stated that the trustee enters into the trust deed as trustee of the trust constituted by the trust deed and not in its personal capacity. However, most (if not all) of the covenants by the trustee under the trust deed are in fact incurred by it personally. This is inherent in the very nature of a trust, whereby a person agrees to hold certain property, on particular terms, for the benefit of another (the beneficiary). It is likely, therefore, that a court would ignore these words if used in a trust deed.

Trustee's liability on the debt securities limited to the trust assets

A trustee's limitation of liability clause typically also provides that the trustee's liability on the debt securities is limited to those amounts which are available to be applied on the debt securities in accordance with the trust deed. These are the critical words from the trustee's perspective (and that of investors). They have the effect of ensuring that the trustee's personal assets are not exposed to the risks of the securitisation and that investors only have rights against the trustee commensurate with the trustee's own ability to debit the trust assets for these amounts.

A trustee's limitation of liability clause is also important in the context of section 197 of the *Corporations Act*. The section provides that a person who is a director of a corporation when it incurs a liability while acting as trustee is liable to discharge that liability if the corporation has not and cannot discharge that liability, and is not entitled to be fully indemnified against the liability out of trust assets. The section also provides that "this is so even if the trust does not have enough assets to indemnify the trustee." These words have been the subject of judicial debate as to their meaning and effect.

One view is that if there are no assets comprising the trust fund, then there is no entitlement to be indemnified and so the directors are personally liable for the outstanding trust debts. This view has been criticised on the basis that it could potentially lead to a situation where a director, who acted properly at the time a liability was incurred (because the right to a sufficient

indemnity existed) and had no hand in subsequent events which rendered the trustee incapable of meeting the liability, is nevertheless held liable for the debt.

In all trust securitisations, as a general rule, the trust deed will provide that the trustee will only be liable to the extent of the assets available to meet the relevant liability. Such a limitation ensures that section 197 will not apply to the transaction and avoids the rule that the directors will be liable if the securitisation trust becomes insolvent.

That being the case, if the trust is liable to third parties who are not bound by the limitation of liability (for example, the Commissioner of Taxation under an outstanding tax liability) then section 197 may apply to the liability and cause the directors to be bound to discharge it if the trust becomes insolvent.

Trustee only personally liable for fraud, negligence or wilful default

Typically, a trustee's limitation of liability clause also provides that the trustee will only be personally liable for any loss suffered by an investor as a result of the trustee's fraud, negligence or wilful default (or similar). This is a standard requirement of the trustee companies, however, it has interesting implications which are perhaps not fully appreciated.

By requiring these words trustees place themselves in a special category. In order to be personally liable not only must the trustee breach the terms of the relevant transaction document, but an additional quality must be shown, that is, in committing the breach the trustee was fraudulent, negligent or in *wilful* default. Normally, though, if a person breaches a term of a contract, nothing more needs to be demonstrated for the person to be personally liable to compensate those who have the benefit of the term for their loss. For example, it is not necessary to show that the breach was wilful; an inadvertent or accidental breach is sufficient as a party to a contract is expected to put in place procedures to ensure that it complies with its terms.

Also, the words "negligence" and "fraud" introduce other doctrines of law that are not usually relevant to contract or trust law. Negligence for example, is founded on a separate legal principle and is usually associated with personal, financial or property injury cases (motor vehicle accidents, occupier's liability and the like). Also, it is unclear whether fraud in this context means criminal fraud or the much lesser notion of equitable fraud which turns on the proper exercise of a power for unintended purposes or taking into account irrelevant matters in considering whether or not to exercise a power.

The reply of the trustee companies to this issue is that their role is equivalent to custodians only and that it is the manager who

has the day-to-day responsibility for the conduct of the securitisation program. In this context, various duties, powers and discretions are accorded to the trustee (often in very general terms). Given their limited role, it is appropriate that a trustee ought to have additional protection against a claim that it should (or should not) have exercised a particular duty, power or discretion.

However, this reasoning is less convincing where the trustee covenants that it will (or will not) do a particular act or thing. Investors and counterparties are entitled to expect that the trustee will perform the covenant and they should be entitled to compensation for any loss they suffer if the trustee fails to do so.

For the time being, wording of this nature is deeply ingrained into trustee thinking and is well accepted by the securitisation market in Australia. It is likely that as the market develops, however there will be a greater focus on whether a more sophisticated formulation is appropriate to better balance the legitimate interests of trustees (on the one hand) and investors and counterparties (on the other).

10.4 Promissory notes issued by trustees

Sometimes the structurers of a securitisation program may wish for a trustee to issue short-term debt instruments. There are a number of benefits if these can be structured as promissory notes. Promissory notes are not subject to the *Corporations Act* (see section 2) and their issue and transfer does not attract stamp duty. In addition, certain benefits regarding negotiability and title are conferred on promissory notes by the *Bills of Exchange Act* which are not available to other types of debt securities.

This therefore raises the issue of whether a trustee can issue a debt security which qualifies as a promissory note for legal purposes.

A promissory note is defined in section 89(1) of the *Bills of Exchange Act* as "an unconditional promise in writing made by one person to another, signed by the maker, engaging to pay, on demand or at a fixed or determinable future time, a sum certain in money, to or to the order of a specified person, or to bearer".

A requirement of the definition is that for an instrument to qualify as a promissory note it must contain an unconditional order or promise to pay a sum certain in money. It is with this in mind that some doubt has been expressed on two grounds whether or not a promissory note issued by a trustee, with its liability limited to the assets of the particular securitisation trust, qualifies as a promissory note.

It is said that the limitation on the trustee's liability to the assets of the trust constitutes an order to pay out of a particular fund. Section 8(3) of the *Bills of Exchange Act* deems such an order not to be *unconditional* as the fund may be insufficient to pay the amount on the face of the instrument. It is also argued that the effect of the limitation on the trustee's liability is that the instrument cannot be for a sum *certain* as the amount that the holder will be entitled to on maturity depends upon assets of the trust being available at that time.

The alternative view is that when a trustee of a trust signs a promissory note containing a limitation on its liability, it does so in a representative character which is authorised by section 31(1) of the *Bills of Exchange Act*. Although there is case law to support this proposition, it is very old and predates the statutory codification of the rules relating to promissory notes in the *Bills of Exchange Act* (and its English predecessor).

The reasoning in these cases is also not particularly clear and there is no certainty whether they would be followed if the situation was examined by the courts today. While there are grounds for concluding that trustees can issue promissory notes containing a limitation on their liability, this issue attracts considerable attention where it is proposed. In order to avoid this, unless it is essential, it is probably better to structure a transaction on the basis that the instruments to be issued by the trustee are not, for legal purposes, promissory notes. Most of the advantages in using promissory notes can be achieved in other ways, avoiding undue legal attention on the integrity of a proposal based on the purported issue of promissory notes by a trustee.

10.5 Can trustees purchase their own securities?

With the enormous growth of managed and superannuation funds over the last few years, these are becoming an increasingly important market as purchasers of securitised instruments. However, in Australia we have a very concentrated professional trustee company industry. Often, the same trustee company will wish to acquire in the open market for a managed fund the debt securities it issued as trustee of a securitisation trust. This then raises the issue of what are the consequences (if any) if this occurs?

The position of a company which acquires its own debt securities, and then subsequently transfers these to another, was considered in *Re George Routledge & Sons Limited* [1904] 2 Ch. 474.

The facts of the decision were as follows: A company issued a series of first mortgage debentures. From time to time some of these came into the market and 16 were purchased back by the company. They were transferred from the sellers to the company and the company's name was entered upon the register of debenture holders. Subsequently, the company transferred the debentures that it had acquired to various third parties.

The issue before the court was whether the purchasers were entitled to be treated as holders of the debentures acquired from the company. The court held that the purchasers had not acquired the debentures.

The reasoning of the court was that the debentures, when they were acquired by the company, ceased to exist. The company could not at the same time be both a debtor and creditor to itself. As the debentures had ceased to exist, they could not be purchased by the third parties. The purchasers acquired nothing (except an unsecured claim against the company for breach of the contract of purchase).

The decision in *Re George Routledge & Sons Limited* raises the prospect that when a trustee purchases its own debt securities, these are extinguished. If this is the case, then it would strictly seem that the trustee, in its capacity as trustee of the purchasing trust, is not entitled to payment of any principal or interest or to the benefit of any other rights accruing under the debt security. In addition, it cannot sell the debt security to a third party for, as indicated above, the purchasers are at law acquiring nothing. This in turn would expose the trustee for an action in damages from the purchaser for failing to deliver the debt security.

It is quite conceivable given fluctuations in interest rates, and perhaps the addition of interest at the relevant Supreme Court rate, that the amount of damages owed by the trustee could exceed the purported sale price of the debt security. This then raises the issue of from which trust would the trustee be entitled to obtain recoupment, the original securitisation trust or the purchasing (and selling) trust?

It would be no overstatement to state that these consequences diverge from the expected commercial consequence that the trustee should be able to hold the debt security and receive interest and principal on it from the securitisation trust and the trustee should be able to validly assign the debt security to a third party.

The effect of the decision has been partly mitigated by section 563AAA of the *Corporations Act*. This provides that “debentures of a company under a trust deed that are issued in place of debentures under that deed that have been redeemed have the priority that the redeemed debentures would have had if they had never been redeemed”.

Section 563AAA does not seem to have been drafted with the position of trustees in mind. Literally, it would seem if section 563AAA applies, the debt securities, while being held by the trustee in its capacity as trustee of the purchasing trust, are regarded as cancelled (and so the purchasing trust does not have an entitlement to receive interest or principal from the securitisation trust). If a subsequent sale by the trustee can be construed as a reissue of the debt security, it is then brought back into existence with the same priority as the original debt securities. This then raises the question of from which trust’s assets does the trustee have a right of recoupment on the debt security – is it the original securitisation trust or is it the trust that sells the debt securities?

It is also important to appreciate that section 563AAA is limited to debentures and many of the debt securities that are traded in the market may not satisfy the statutory definition of this term (eg. promissory notes).

The decision in *Re George Routledge & Sons Limited* and section 563AAA contemplate that the company when issuing debentures, and when repurchasing the debentures, is doing so

in the same capacity. This raises the issue of whether the law will recognise that the trustee, when issuing debt securities as trustee of a securitisation trust, is acting in a different capacity when it purchases the debt securities as trustee of another trust.

There are a number of references in the texts and the cases suggesting that a person has the capacity to contract with himself, but in a different capacity. Unfortunately, these deal with fact situations different from debt securities (although perhaps the same principles should apply) and the results in those decisions can be explained on other grounds which are not relevant here.

Based upon the foregoing, there is considerable doubt regarding the consequences where a trustee of a trust purchases debt securities issued by it as trustee of a securitisation trust. If issuers of securitised instruments are to tap into the potential market presented by funds under management in Australia, it would seem necessary for this issue to be clarified by an amendment to the *Corporations Act*.

10.6 Conclusion

The development in Australia of trust structures issuing debt securities raises many interesting and unique issues, both from a drafting and a legislative perspective. Most of these have now been resolved to the satisfaction of all interested parties. The next section reviews the listing requirements for securitised instruments on the Australian Stock Exchange.

11 Listing of debt securities

11.1 Introduction

This section deals with the requirements for listing debt securities on the Australian Stock Exchange (ASX).

To satisfy the requirements of some investors whose mandates require securities to be listed, issuers often seek to list their securities on an internationally recognised exchange. Issues of debt securities into the global or euro markets are typically listed on exchanges in offshore financial centres such as London, Ireland or Luxembourg. Listings on these exchanges are normally effected by offshore listing agents, and depending on the complexity of the listing rules for the relevant exchange, offshore legal counsel may also be appointed.

Issues of debt securities into the Australian market are more likely to satisfy investor listing requirements by seeking a quotation of their debt securities on the ASX. Listing on the ASX has been rare in the past, and is still not usual, but has increasingly occurred as “domestic” Australian dollar issues of notes are increasingly sold offshore including to investors who require, or would prefer, that the notes be listed.

11.2 ASX requirements for listing of debt securities

Before an issue of debt securities can be quoted on the ASX, the listing entity must:

- (a) apply for admission to the official list of the ASX as an ASX Debt Listing by completing an application and providing certain prescribed information;
- (b) be a public company limited by shares, a government borrowing authority, a public authority or an entity approved by the ASX;
- (c) have net tangible assets at the time of admission of at least A\$10 million (or be irrevocably guaranteed by a parent which meets this asset test for the period of the quotation of the securities and agrees to provide certain undertakings);
- (d) be seeking a quotation of debt securities only (as opposed to equity securities or convertible notes) in an aggregate value of at least A\$10 million and for an issue price of at least 20 cents (special rules also apply to partly paid securities);
- (e) be granted quotation of all the securities that are in the class for which it seeks quotation;
- (f) satisfy any CHES requirements relating to the settlement of the securities;
- (g) comply with the timetable prescribed by the ASX for interest payments;

- (h) appoint a person to be responsible for communication with ASX in relation to listing matters; and
- (i) agree to provide (and authenticate) documents electronically to the ASX and establish the facilities required for this purpose.

If the listing entity is a foreign entity, certain additional rules apply. If the listing entity has already been admitted to the official list as an ASX Debt Listing, the quotation of additional securities subsequently issued by that entity will be governed by another similar set of rules.

Where the listing entity is an issuer trustee, it is unlikely to satisfy the requirements in (b) above unless it is approved by the ASX. Additionally, because of the nature of securitised transactions and the debt securities, the subject of the listing application (which are usually settled through Austraclear), waivers of the requirements in (c), (f) and (g) above are typically granted by the ASX on application by the listing entity.

The listing entity gives certain warranties and indemnities to the ASX in the listing application including that the issue of securities to be quoted complies with the law, and is not for an illegal purpose.

Fees will be payable by the listing entity in respect of each listing application.

Quotation of any entity's securities is in the ASX's absolute discretion. If a listing entity is admitted to the official list as an ASX Debt Listing, the application form, the information memorandum and the other transaction documents which constitute the issuer trust or are otherwise relevant to the terms of the issue may be made publicly available by the ASX.

11.3 Listing rules form contract between ASX and trustee

The admission of entities to the official list and the quotation on the ASX of debt securities issued by that entity are governed by the ASX listing rules. These rules, which are contractually binding on the listed entity, also govern the ongoing disclosure regime and reporting requirements applicable to listed entities and some aspects of a listed entity's conduct.

The key continuous disclosure rule is listing rule 3.1. This provides that once an entity is or becomes aware of any information concerning it that a reasonable person would expect to have a material effect on the price or value of the listed securities, the entity must immediately tell the ASX that information. While there are exceptions in listing rule 3.1A,

the ASX has discretion to ask the entity to provide the information, notwithstanding the exceptions if the information is necessary to correct or prevent a false market.

The ASX has recognised that certain listing rules are not appropriate for securitisation transactions and, on application by the listing entity, will typically grant waivers of these rules, as it considers appropriate.

11.4 Consequences of breach of the listing rules

If an entity admitted to the official list does not comply with the listing rules, its securities may be suspended from quotation or it may be removed from the official list.

The court may also make such orders as it thinks fit on the application of the Australian Securities & Investments Commission, the ASX or a person aggrieved by the alleged contravention of the listing rules. However, the court can only make such an order if the court is satisfied that the order would not unfairly prejudice any person.

Failure by a person to comply with the continuous disclosure obligations under the listing rules is a criminal offence under the *Corporations Act* if the information which is not disclosed is not generally available and is information that a reasonable person would expect (if it were generally available) to have a material effect on the price or value of the listed securities. Contravention is also a civil penalty provision under the *Corporations Act*, as to which limited defences are available.

A breach of the listing rules may also give rise to a market offence for the purposes of Part 7.10 of the *Corporations Act*. Examples of the types of conduct caught by Part 7.10 include market manipulation, making of false or misleading statements, inducing a person to deal or dishonest conduct.

12 An overview of the legal aspects of the Austraclear System

12.1 Introduction

Austraclear settles approximately \$16 billion in debt securities and other money market transactions on a daily basis and holds on average over \$500 billion of securities in its system.

Austraclear clearly plays a significant role in the Australian financial system. Its significance is particularly evident in securitisations in the Australian debt capital markets. The role of Austraclear with respect to the safe custody, electronic trading and clearing system for debt securities is crucial in the facilitation of securitisation transactions in Australia.

Accordingly, an understanding of its operations and capabilities is essential to an understanding of the practical aspects of a securitisation in Australia, ie. the issue of debt securities.

This section describes the facilities provided by Austraclear, the types of securities permitted to be lodged and traded within its system and the mechanisms adopted to minimise the credit risk to Members against the clearing system in relation to their lodged securities.

At the time of writing, Austraclear is foreshadowing that it will amend the Austraclear Regulations and the Austraclear System Operating Manual to coincide with the introduction of new software for the Austraclear System and to reflect Austraclear's recent regulation pursuant to Pt 7.3 of the *Corporations Act*. This will lead to changes in terminology (for example, from "Member" to "Participant") and to the combination of the Austraclear rules into a single document. Nevertheless, the fundamental nature of the Austraclear System as well as the relationship, rights and obligations of Members will not change.

12.2 Austraclear, the Austraclear System and its services

Austraclear Ltd was established in September 1984. It is a licensed clearing and settlement facility under Pt 7.3 of the *Corporations Act*. As such, it must comply with the requirements of that Part, including the Reserve Bank of Australia's financial stability standards under section 827D.

The services provided by Austraclear to its Members occurs within the "Austraclear System". The Austraclear System provides four key functions:

- the lodgement of securities – Austraclear has a depository service which allows its Members to lodge paper debt securities with Austraclear;
- the safe custody of paper securities – Austraclear arranges for paper securities lodged with it to be kept in a safe manner and deposits those securities in safe-keeping accommodation;

- the entry of transactions – Austraclear provides a facility for the electronic transfer between Members of the securities lodged with it; and
- the settlement of transactions – Austraclear provides for settlement of transactions within its system with the simultaneous payment for securities on a real time gross basis and the transfer of clear title to those securities.

Austraclear Services Ltd, a wholly-owned subsidiary, also offers issuing and paying agent and registry services for issuers of debt securities.

The Austraclear System is constituted by the Regulations and the Operating Manual. Each Member is bound by and must comply with the Regulations and the Operating Manual. The Operating Manual supplements the Regulations and sets out the day to day details for implementing the provisions of the Regulations.

12.3 Membership of Austraclear

Financial institutions wishing to use the Austraclear System are required to become Members. There are at present over 600 Members, who comprise major participants in the debt capital markets, including banks, government and semi-government bodies, insurance and superannuation companies, trustee companies, non-bank financial institutions and larger corporations. There are four classes of Membership available to suit a participant's level of activity or status. These are:

- Full Membership – for professional dealers and other participants in the debt capital markets.
- Associate Membership – for occasional participants in the financial markets. An applicant for an Associate Membership must be nominated by a Full Member. An Associate Member has all the responsibilities of a Full Member, but is subject to a number of important limitations on its activities in the Austraclear System.
- Special Purpose Members – this category has four types of Members being clearing houses, exchanges, regulatory bodies and any other kinds of entities approved by the Austraclear Committee. The Austraclear Committee periodically determines the rights and obligations of the Special Purpose Members.

- Public Trustee Members – for professional trustees of trust funds to access the Austraclear System. Regulation 5.3 provides that the liability of a Public Trust Member in respect of transactions and acts or omissions is limited and will not exceed the assets of the trust for which that member is trustee and which is available to meet that liability.

Regulation 3.5 requires each Member to arrange for a Participating Bank to make payments in the system on the Member's behalf. Under regulation 1.1 a "Participating Bank" is a bank or other entity which is a member of the Reserve Bank Information and Transfer System (RITS) and Real Time Gross Settlement System (RTGS) and has an exchange settlement account with the Reserve Bank. The RITS/RTGS is the system owned and operated by the Reserve Bank for the real time gross settlement of transfers between accounts of Participating Banks with the Reserve Bank.

A Member must maintain a Nominated Account with its Participating Bank. Pursuant to regulation 3.6(b), a Participating Bank is liable for the obligations of its client Member under the Regulations if the Member becomes insolvent and has failed to fulfil its outstanding obligations in relation to any transaction which has been settled by the Member through its Participating Bank. Although a Participating Bank does not guarantee its client Member's obligations generally, it does in effect underwrite their creditworthiness to other counterparty Members in relation to settled transactions.

12.4 The relationship between Austraclear and its Members

The Regulations seek to create a multilateral contract between Austraclear, its Members and Participating Banks. Regulation 23.3 provides that:

"(d) [the] Regulations are a valid, binding and enforceable contract between each and every Member, Participating Bank and Austraclear; and

(e) in contracting pursuant to the preceding paragraph with each Member and each Participating Bank, Austraclear contracts as agent and trustee for each other Member and each other Participating Bank as well as on its own behalf, so that the rights which Austraclear thereby has to enforce these Regulations as a contract against any person will be rights exercisable on its own behalf as well as on behalf of and for the benefit of all other members which are Members or Participating Banks from time to time."

Regulation 23.4 also provides that "unless expressly agreed, neither Austraclear nor another person, by reason of [the] Regulations, the Operating Manual or any other document relating to the System has a fiduciary relationship with, or is trustee for a Member, a Participating Bank or another person".

12.5 What types of securities can be lodged in Austraclear?

Four types of securities can be lodged and traded within the Austraclear System:

- Paper Securities;
- Non-Paper Securities;
- Euroentitlements; and
- Dematerialised Securities.

12.5.1 Paper Securities

Paragraph 1.1(g) of the Operating Manual specifies the kinds of securities acceptable for lodgement in the Austraclear System as Paper Securities. The Paper Securities which are accepted by Austraclear are set out in regulation 1.1 and include bank and non-bank negotiable certificates of deposit, promissory notes and bills of exchange which, in each case, meet certain criteria.

Representations and warranties

A Member lodging a Paper Security in the Austraclear System provides the representations and warranties in regulation 7.5. These include that the Paper Security and the signatures appearing on it are genuine and not forged or fraudulent; that the Member has, or has a right to pass, good and unencumbered title to the Paper Securities; that it is duly drawn, accepted or endorsed as appears on it; and that the Member will be liable for any apparent or concealed defects concerning the Paper Security. Paper Securities are physically lodged with Austraclear. Regulation 7.8 provides that Austraclear must arrange for all Paper Securities to be kept in a secure manner and for Austraclear to deposit Paper Securities in the safe-keeping accommodation provided by it.

Lodgement, transfers and Bills of Exchange Act

When a Paper Security is lodged by a Member, Austraclear records the Paper Security in the Member's Security Record. The legal title to the Paper Security remains with the lodging Member. Austraclear holds the Paper Security as bailee for the lodging Member and each subsequent Member in whose Security Record it appears from time to time.

On settlement of a transfer of a Paper Security, title to it becomes vested in the transferee. This occurs in accordance with the general law and the transfer is not affected by the Regulations or the Operating Manual.

While the Regulations and the Operating Manual provide a regime for transfer and settlements within the Austraclear System, Paper Securities are negotiable instruments. As such, they are also governed by the *Bills of Exchange Act*. Paper Securities are bearer instruments for the purposes of the *Bills of Exchange Act*, either because they are expressed to be payable to bearer or their last endorsement is in blank (13(3) of the *Bills of Exchange Act*). Under s 36(2) of the *Bills of Exchange Act*, the transfer of title in a bill payable to bearer occurs by delivery. Within the Austraclear System, this occurs constructively and arises by virtue of the change in the terms and status of Austraclear's bailment. It no longer holds the Paper Security as bailee for the transferor but instead for the transferee.

The Regulations also seek to permit Members to have the benefit of the endorsement provisions of the *Bills of Exchange Act*. Regulation 12.3 provides that a transfer between Members of a lodged Paper Security may be on terms that the Paper Security is indorsed by the transferring Member. If this occurs, it must be entered by the parties into the system and Austraclear must record in the description of the Paper Security the name of the Member who has agreed to indorse it. Each indorsing Member is then liable to other Members to the full extent as if the indorsing Member had actually signed the Paper Security as indorser.

12.5.2 Non-Paper Securities

Non-Paper Securities are defined in regulation 1.1 as debt obligations of a government, government authority, any corporation or other body corporate or any legal or equitable right or interest in such a debt obligation or in a pool of such debt obligations, where the debt obligation or the right or interest is of a kind prescribed in the Operating Manual. Paragraph 1.1(f) of the Operating Manual provides that, for a security to be acceptable for lodgement in the Austraclear System as a Non-Paper Security, the terms and conditions of issue must provide, amongst other things, that a register will be maintained by or on behalf of the issuer to record the name of the legal owner of that security. The result is that Non-Paper Securities are registered debt securities. These are not represented in physical form and investors do not receive written definitive evidence of their title or the issuer's indebtedness to them. Instead, the relevant debt

obligation usually arises under a deed poll. The issuer's indebtedness is noted in a register which is conclusive. Many debt securities issued in securitisations are register-based Non-Paper Securities, traded through Austraclear.

Lodgement and transfers

Non-Paper Securities must be lodged with a valid marked and executed transfer and acceptance form, with the lodging Member as transferor and Austraclear as transferee. The securities are entered into the Security Record of the lodging Member but they are transferred to Austraclear pursuant to the transfer and acceptance form which is lodged with the issuer's registry.

Regulation 8.1 provides that the legal title to a Non-Paper Security is held by Austraclear until it is uplifted from the system. The beneficial interest is retained by the lodging Member until the Non-Paper Security is uplifted or transferred to another Member. Regulation 8.4 also provides that Austraclear holds a lodged Non-Paper Security as "nominee" for the Owner and must deal with the security in accordance with its directions and instructions.

Non-Paper Securities can be transferred between Members of Austraclear. Such a transfer operates to assign the beneficial title to the transferee Member on settlement. Austraclear thereafter holds the Non-Paper Security as "nominee" for the transferee Member. Throughout the process of electronic trading of a Non-Paper Security while it is lodged on the system, there is no change in the registered legal holder, which remains Austraclear.

12.5.3 Euroentitlements

Euroentitlements are securities which have been lodged with Euroclear or Clearstream. Under paragraph 1.1(e) of the Operating Manual the securities must be denominated, and all payments must be made, in Australian currency. The securities must be rated "investment grade" by S&P, Moodys, Fitch or another rating agency acceptable to Austraclear and the securities must be approved by the Austraclear Committee.

Lodgement and transfers

In order to lodge a Euroentitlement with Austraclear, a Member must, amongst other things, direct Euroclear or Clearstream, in accordance with their rules, to transfer the relevant eurosecurities from the Member's account to the account of Austraclear on a "free of payment" basis. A financial institution which is not a participant in Euroclear or Clearstream can arrange for such a person to do this on its behalf.

When Austraclear receives notification from Euroclear or Clearstream that the transfer has taken place, it then credits the nominated Security Record of the lodging Member with the relevant Euroentitlements.

Once the lodgement procedure has been completed, transactions in Euroentitlements are recorded in exactly the same way as for other types of securities lodged in Austraclear. Austraclear holds the Euroentitlement as nominee for the relevant Owner and must deal with it in accordance with the Owner's instructions.

12.5.4 Dematerialised Securities

Dematerialised Securities are created electronically and are not represented by a physical instrument. They are intended to be equivalent to certain classes of Paper Securities.

Dematerialisation has the advantage of removing one step in the trading transaction – that of issuing and reissuing physical certificates. It permits a streamlining and simplification of the issue process, leading to savings in operating time and the costs of registration.

The obligations of the issuer to holders under a Dematerialised Security are set out entirely in the Regulations and the Operating Manual and are effective by virtue of the contract between the Members. It follows that an issuer of a Dematerialised Security must be a Member of Austraclear and that a Dematerialised Security while in this form can be traded and held only by Members.

Regulation 8B.2 provides as follows:

“(b) the records of Austraclear prove the terms and the execution of a Dematerialised Security in the same way and with the same effect as the Equivalent Paper Security;

(c) the rights and obligations of a person who is deemed to be the issuer, drawer, maker, acceptor, indorser or holder of a Dematerialised Security are to be equivalent to those to which that person would be entitled or subject if it were the issuer, drawer, maker, acceptor, indorser or holder (as the case may be) of an Equivalent Paper Security, notwithstanding that the relevant rights and obligations have not been embodied in a document which satisfies the requirements for formal validity of the Equivalent Paper Security.”

In addition, under regulation 8B.2(e) each Member and Participating Bank is estopped from asserting that the rights of the holder of a Dematerialised Security differ from those the holder would have if it held the Equivalent Paper Security.

Lodgement and title

The process for creating and lodging a Dematerialised Security is contained in paragraph 8A.1 of the *Operating Manual*. In short, a Member enters into the system electronically all of the essential qualities of the Dematerialised Security, such as the details of its corresponding Equivalent Paper Security, its issue and maturity dates, the face value, the drawer, the acceptor/issuer or maker, the payee, the place at which it is payable and so forth. Once the Dematerialised Security is accepted for lodgement, it becomes a valid debt security in accordance with its terms.

Dematerialised Securities are intended to be equivalent in all respects to their Equivalent Paper Securities. However, while they are in electronic form, the provisions of the *Bills of Exchange Act* cannot apply to them. The Regulations seek, though, to replicate the position.

This is achieved, indirectly, through regulation 8B.2(c) (see above) which confers in respect of a Dematerialised Security all the qualities applying to its Equivalent Paper Security. These include, presumably, those under the *Bills of Exchange Act*. In this respect, perhaps the most interesting aspect is the attempt by the Regulations to replicate the benefits of a holder in due course under the *Bills of Exchange Act*.

Regulation 8B.1 provides that “the owner of a Lodged Dematerialised Security has good title to it if the Member has taken that Dematerialised Security in good faith for value and without notice at the time of taking title of any defect in the title of its immediate predecessor in title.” In addition, regulation 8B.2(f) provides:

“where a Member acquires a Dematerialised Security by transfer to the Member's Security Record in good faith, for value and without notice of any defect in the title of the transferor ... the Member acquiring the Dematerialised Security will have rights in relation to its equivalent to those of a holder in due course of the Equivalent Paper Securities and will accordingly acquire a title to that Dematerialised Security which is free of equities.”

Regulations 8B.1 and 8B.2 are binding on the Members. As such the Regulations should be effective in determining any disputes amongst them regarding the title to a Dematerialised Security and for curing any defects to a Member's title.

12.6 Encumbrances over lodged securities

The Austraclear System permits a Member (an encumbrancer) to grant an encumbrance over a security in its Security Record in favour of another Member (an encumbrancee). The encumbrancer and encumbrancee must enter into the Austraclear System the details of the encumbrance. Austraclear must then amend the Security Record of the encumbrancer so that the encumbered security and its encumbrancee are identified. The effect of this is that Austraclear thereafter will recognise the encumbrancee as the only Member entitled to transfer or uplift the encumbered security.

Regulation 9.5(b) provides that as between the encumbrancer and encumbrancee the terms of the encumbrance may be as agreed between them. If, though, the only evidence of the agreement is the entry into the Austraclear System of the notification of the encumbrance, then:

- in the case of a Paper Security, the encumbrance operates as a pledge of the security where the encumbrancee is taken to have constructive possession of it;
- in the case of a Non-Paper Security, the encumbrance operates as an equitable mortgage with Austraclear being registered on the issuer's register as "nominee" of both the encumbrancee and the encumbrancer; and
- in the case of a Euroentitlement or a Dematerialised Security, the encumbrance operates as an equitable mortgage.

12.7 Uplift of securities

The Regulations permit an owner of a security to uplift it out of the Austraclear System. The following uplift mechanisms are in place for the different forms of securities lodged with Austraclear.

12.7.1 Paper Securities

Where a Paper Security is to be uplifted, Austraclear will withdraw it from safekeeping, remove its details from its Owner's Security Record and release it to the Owner or as it directs. If the Paper Security has been the subject of indorsements, Austraclear must prepare and sign an allonge bearing the name of each indorsing Member and attach it to the Paper Security.

12.7.2 Non-Paper Securities

In order to uplift a Non-Paper Security, a Transfer and Acceptance Form must be executed by Austraclear as transferor

and the Uplifting Member as transferee and lodged with the issuer's registry so as to transfer the legal title from Austraclear to the uplifting Member.

12.7.3 Euroentitlements

Uplifts of Euroentitlements occur by reversing their lodgement procedure. This means that a Member must either be a participant in Euroclear or Clearstream or have an arrangement with such a participant in order to uplift its Euroentitlements. The Regulations also allow for Austraclear to require a Member to uplift its Euroentitlements in certain circumstances.

12.7.4 Dematerialised Securities

In the case of a Dematerialised Security, a physical version of the Dematerialised Security must be prepared replicating all aspects of it, namely, the date of issue and acceptance and the payee's indorsement (if applicable). The physical form must be presented to the maker, issuer or drawer, and to any acceptor, for signature by them in their respective capacities. Under regulation 10.5, Austraclear is appointed to sign any Dematerialised Security in physical form as attorney of the Member upon uplift for which the Member is issuer, maker, drawer or acceptor. Once it has been so signed, the physical version must be delivered to Austraclear in order for an uplift to be effected. The physical security then replaces the Dematerialised Security. However, if the physical security is not enforceable or is void or voidable, the Dematerialised Security is "resuscitated".

12.8 The settlement of transactions through Austraclear

The settlement of the transfer of securities within the Austraclear System occurs on what is known as a "delivery - versus - payment" model. That is, ownership of securities does not change in Austraclear's records until the system receives advice that the funds payable in respect of that transfer have been cleared.

12.8.1 Cash Account and Security Record

Austraclear maintains a Cash Account and Security Record for each Member. When a transaction occurs between Members, the details are entered by both of them into the Austraclear System. Once the transaction is "matched" in the System, it proceeds to settlement testing. A Member's obligation to deliver securities or to make payment is calculated on a gross basis. If the relevant securities are available in the transferor Member's Security Record and the necessary credit and liquidity checks

have been completed in relation to the transferee Member, the transfer of funds for the transaction takes place in Reserve Bank funds across exchange settlement accounts of the corresponding Participating Banks held with the Reserve Bank. A Participating Bank can control its credit exposure to a client Member by setting a limit on the maximum debit balance of the Member's Cash Account within the Austraclear System. The system does not allow transactions to be settled which breach the limit. Simultaneously, the Cash Accounts and the Security Records of the relevant Members are updated to reflect the settlement of the transaction.

12.8.2 Payment

The settlement of transactions in the Austraclear System is governed by regulations 14, 15 and 16. Under regulation 15, payment obligations are usually settled through RITS/RTGS. The Payments System Board of the Reserve Bank has approved the Austraclear System as an "approved RTGS system" pursuant to section 9 of the *Payment Systems and Netting Act 1998 (PSN Act)*. Accordingly, pursuant to section 6(1), if a Member goes into "external administration" and a payment or settlement transaction is executed through the Austraclear System at any time on the day on which the external administrator is appointed and the transaction involves the payment of money or the transfer of an asset by the Member, that payment or transfer has the same effect it would have had if the Member had gone into external administration on the next day. The *PSN Act* also provides that section 6 has effect despite any other law.

This ensures the irrevocability of completed Austraclear transactions by removing the application of the "zero hour rule" in the event of a Member's insolvency. This rule provides that a judicial act is taken to date from the earliest point on the day on which it occurs. Accordingly, any disposition of property of the Member after this time on the day of the commencement of its winding up is void under section 468 of the *Corporations Act*.

Without the PSN Act, any RTGS payment between midnight and the time that a winding up order is made would be void. This would result in no payment in Austraclear being presumed final until the end of the day on which it was made. Accordingly, the Act ensures a completed RTGS transaction cannot be later unwound if a Member is declared insolvent. Importantly, however, the PSN Act does not preclude the operation of section 588FE of the *Corporations Act* to permit a liquidator to reclaim certain payments.

12.8.3 Back-up settlement facility

If for any reason RITS/RTGS is not operating, there is a back-up facility for settlement in place under regulation 16. This involves multilateral netting between Austraclear, the Members and Participating Banks. The Payments System Board of the Reserve Bank has approved the Austraclear System as a multilateral netting system under the PSN Act where real time settlement is not available. Pursuant to section 10(2), a party to an approved netting arrangement may do anything permitted or required by the arrangement in order to net obligations incurred before or on the day on which it goes into external administration. Section 10(2)(e) provides that the netting and any payment made by the party under the arrangement to discharge a net obligation is not voidable in the external administration.

12.9 Conclusion

Austraclear plays a pivotal role in the issuance of debt securities and the clearance and settlement of securitisation transactions in Australia. It provides an electronic trading and clearing environment, as well as custody services, for debt securities. It encourages liquidity in the market, which is an essential precondition to participation by many investors.

The *Regulations* and the *Operating Manual* provide the legal framework for the operations of Austraclear. The next section of this publication reviews the position of commercial mortgage-backed securities in the Australian context.

13 Commercial mortgage-backed securities

13.1 Overview of CMBS

A commercial mortgage-backed securities transaction typically involves an issue of debt securities, cash flows in respect of which are underpinned by the rental income of pooled assets consisting of a cross-collateralised or cross-defaulted portfolio of real estate. The pooled assets are secured for the benefit of holders of the debt securities.

Payments are limited to the proceeds from the underlying assets. The secured assets are isolated from other operations of the entity through the creation of a special purpose entity (SPE) or the use of managed investment schemes.

The security pool may comprise the same property type or different types of real estate such as commercial, industrial and/or retail properties.

The rating agencies play a critical role in the CMBS market. The rating agencies examine the characteristics of the underlying loan pool such as the debt service coverage ratio (DSCR); the loan-to-value ratio (LVR); the quality and diversity of the pool of properties supporting a particular CMBS; the level of collateralisation provided; credit quality of the tenant(s); the geographical concentration; and the weighed average lease maturity of the collateralised pool.

CMBS may provide a lower cost of funding the underlying properties, as compared to more traditional bank debt, depending on the market for CMBS at the time.

13.2 Structural features

Structural features of a typical CMBS include:

13.2.1 Further indebtedness

The SPE may be allowed to raise additional debt by issuing further debt securities secured by the collateralised pool of properties provided that the further issue of debt securities will not have an adverse effect on the existing debt securities. The ratings agencies will consider the strengths and weakness of any newly-acquired properties which are proposed to be added to the security pool as well as the nature of the proposed further indebtedness.

13.2.2 Amortisation and refinancing

Unlike residential mortgages that are fully amortised over a long time period, issued CMBS are usually interest only with no amortisation of principal until a scheduled maturity date. If refinance is not available at the scheduled maturity date, with the consequence that the CMBS are not redeemed, the

transaction moves into a refinancing period during which the underlying properties may be sold under the security trustee's direction.

Typically, if the CMBS are not fully repaid on the scheduled maturity date then a default is taken not to have occurred. However, the SPE may be required to initiate the sale of the underlying properties and utilise the proceeds from the sale to redeem the notes. The refinancing period is the term between the scheduled maturity date and the final maturity date, at which point the principal of the CMBS must be repaid in full.

During the refinancing period, the coupon on the CMBS will typically increase by a pre-agreed "step-up margin".

CMBS documentation often allows the security trustee to waive compliance with the sale process if the security trustee is satisfied that:

- the issuer has a proposal in place which will enable an imminent refinancing of the CMBS; and
- if that proposed financing were to fall over, there would be sufficient time remaining prior to the final maturity date to undertake an asset sale sufficient to realise enough funds to fully repay holders of the CMBS.

13.2.3 Cross-collateralisation

Diversification of the underlying collateral is one way of reducing default risk. Another way to reduce default risk is to use cross-collateralisation. In cross-collateralisation or cross-defaulted pools of properties, the cash flow from each property jointly supports the entire pool, a default on one property triggers a default on the entire pool and the total liquidation proceeds from each and all of the properties are available to repay the debt.

This will usually not be available in a multi-borrower CMBS where the underlying properties are ultimately owned by non-related parties or different management investment schemes.

13.2.4 Right to deal in properties

A transaction can be structured to allow the SPE to both acquire further properties as well as dispose of existing properties, either within agreed criteria prior to the scheduled maturity date or subject to confirmation from the rating agency that there will be no adverse impact to the rating of the Notes.

Further acquisitions may be funded through the issuance of further rated securities, subject to rating agency confirmation.

Some CMBS transactions allow the issuer to acquire new property which is not secured in support of the CMBS, provided that:

- the financing of the acquisition of the new property is strictly limited recourse to the new property only;
- the rating agencies are notified; and
- the acquisition does not have an adverse impact on the rental payable in respect of the existing security pool.

This gives issuers some flexibility in relation to the portfolio of properties supporting the CMBS, an important consideration in many instances, particularly with listed property trusts.

13.3 Other relevant considerations for CMBS

13.3.1 Insurance

This will obviously be important having regard to the underlying assets supporting the CMBS.

Typically, the rating agencies will consider the nature and extent of the insurances as well as the credit worthiness of the insurer(s).

13.3.2 Capital expenditure

The relevance of capital expenditure to a CMBS transaction will depend upon both the type and condition of the underlying properties.

It may be necessary for a capital expenditure fund to be established, and/or for capital expenditure to be taken into account in the cash flow waterfall(s), particularly if the ratings agencies are of the view that this is necessary to ensure that the value of the underlying properties is maintained and that in an enforcement scenario noteholders will not have to effectively fund a substantial amount of capital expenditure in order to attract and/or retain tenants or attain a sufficient sale price.

The next section of this publication examines some of the issues relevant to synthetic securitisations in Australia.

14 Synthetic securitisations

14.1 Introduction

In a synthetic securitisation, the credit risk in relation to specified receivables is transferred to a special purpose vehicle (and from there to investors who acquire notes issued by the special purpose vehicle) without any transfer of the receivables themselves.

As is the case in the United States, the most common form of synthetic securitisation in Australia is a synthetic collateralised debt obligation (a synthetic CDO). In this type of transaction, the special purpose vehicle issues notes (credit linked notes) the repayment of which is linked to the credit of a number of named, and usually well-known, companies (reference entities). If enough of the reference entities become insolvent or default in payment of their debts, noteholders may not receive full repayment of their credit linked notes. Credit linked notes in synthetic CDO transactions have been issued both to retail and to wholesale investors in Australia (and are one of the few securitisation structures in Australia that has retail investors - see section 1).

Synthetic securitisations in Australia have also occurred in relation to:

- corporate loans;
- small and large commercial property mortgages; and
- equipment leases,

amongst other assets.

There are relatively few legal issues associated with synthetic securitisations in Australia. One of the advantages of a synthetic securitisation is that it can avoid the legal problems associated with outright transfers of some assets - and in particular complex tax and stamp duty issues.

The principal legal issue peculiar to synthetic securitisations is whether the risk transfer agreement may be characterised as an insurance contract.

14.2 Insurance contract

The transfer of risk that occurs in a synthetic securitisation will usually be documented by way of a credit swap using International Swaps and Derivatives Association provisions. This is not always the case, however, particularly where the transaction is not a synthetic CDO. Other types of documents, such as financial guarantees, may be used.

Regardless of the document used, there is usually some risk that the risk transfer contract may be characterised as an insurance contract. Like an insurance contract, these transactions involve the transfer of the risk of a future event happening in return for the payment of a fee.

It is important that the risk transfer contract not be characterised as insurance contracts because if it is:

- the transaction will be subject to the *Insurance Contracts Act* 1984 which will incorporate terms into the contract, including duties of disclosure, which may not be appropriate;
- the parties may be conducting an insurance business within the scope of the *Insurance Act* 1973 and, if so, will require authorisation under that Act;
- this will affect the GST treatment of the transactions (insurance contracts are taxable supplies but swaps and guarantees are generally not); and
- insurance contracts are generally subject to stamp duty.

The position under Australian law in relation to characterising contracts as insurance contracts is very similar to that in the United Kingdom. There is no single test for determining whether a contract is an insurance contract, it is a matter of comparing the features of the contract to the usual features of an insurance contract. As in the United Kingdom, the credit swap market in Australia has satisfied itself that there is no significant risk of recharacterisation – principally because there is no necessary requirement in a credit swap that the buyer of protection need suffer any loss for which a payment under the credit swap will compensate (that is, the buyer of the protection need not have any exposure to the reference entities of the relevant credit swap).

The analysis becomes more difficult where the synthetic securitisation relates to assets on a bank's balance sheet (and in particular where the reference entities are not well known entities). Nevertheless, it is usually possible to conclude that these are sufficient differences such as to prevent the risk transfer contract from being characterised as an insurance contract.

14.3 Gaming

In the past, another concern has been that the transfer contract not breach any gaming or wagering laws.

Section 1101I of the *Corporations Act* now provides that a contract in relation to a financial product is valid and enforceable despite any gaming or wagering laws. This would apply to most contracts for the transfer of risk in a synthetic securitisation.

In addition, if the contract is governed by New South Wales law the relevant gaming legislation in that State has a relatively narrow definition of “unlawful game” which is unlikely to apply to these types of transactions.

14.4 Conclusion

Synthetic structures are now widely accepted in both the wholesale and retail markets. They are unlikely ever to approach the volume of traditional securitisations. But we would expect more transactions in coming years as banks increasingly tailor products to investor demands.

15 Conclusion

This publication by Clayton Utz has attempted to highlight some of the critical legal issues, and the reasoning behind these, that affect securitisations in Australia. The foregoing is not an exhaustive analysis, and inevitably other issues need to be considered depending on each instance. The issues are complex, and given the relatively brief history of securitisation in this country, there is often some uncertainty as to the conclusions.

As the industry matures, many of these issues will abate on the basis of having been satisfactorily resolved, but it is certain that the law will continue as a fundamental component in the structuring of any successful issue of mortgage or asset-backed securities.

16 Clayton Utz

Our securitisation team

As Australia's pre-eminent law firm in securitisation, Clayton Utz has been involved in almost every significant securitisation transaction in recent years. Our clients include the major issuers in the mortgage and asset backed securities markets, the leading program arrangers, trustee companies and dealers as well as many of the more prominent credit enhancers and liquidity providers.

Clayton Utz has the largest securitisation team of any law firm in Australia. Our lawyers provide expertise, innovation and depth through their industry knowledge, understanding and involvement. We understand the resources that securitisation projects require and we provide a complete legal service across all areas such as capital markets, structured finance, trustee and company law, consumer credit, stamp duty, tax and rating issues.

Our commitment to the success of the industry goes beyond structuring and documenting transactions. Since the emergence of securitisation in Australia, we have contributed to fostering the development of the industry. Clayton Utz was one of the founding members of the Australian Securitisation Forum, an industry body established to promote securitisation and actively lobby for the removal of any impediments to its development in Australia. We have also been a member of the Mortgage Industry Association of Australia from its earliest days.

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