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1. Introduction

The impact of the credit crunch on the international capital markets over the past 12 months has been well documented, and its ramifications are likely to continue to be felt for some time.

However, there has been some good news from the legislative and regulatory perspective in the past 12 months in relation to the issuance of capital markets instruments into the Australian market:

- **repos**: the range of instruments accepted for repo purposes by the Reserve Bank of Australia (***RBA***) has been expanded to include certain Kangaroo bond issues;
- **mutual recognition regime**: a regime has been introduced for the mutual recognition of securities issued into other jurisdictions, with New Zealand being the first jurisdiction with which Australia has formalised mutual recognition arrangements, and there have been positive steps towards this being reflected for other jurisdictions; and
- **investment by general insurers**: the issues relating to the acceptability for investment of Kangaroo bonds by general insurers have been resolved.

On the downside, there has been confirmation of the continued exclusion of covered bond issuance by Australian ADIs – which although not directly impacting upon Kangaroo covered bond issuance, may have a residual effect.

Each of these issues is considered below.

2. Repos

2.1 Introduction

In late 2007, the RBA broadened the range of instruments with respect to which it is prepared to enter into repos.

Prior to September 2007, the securities accepted were Australian commonwealth government securities, securities issued by Australian state and territory borrowing authorities, securities issued by some supra-national and foreign government agencies, and bills and certificates of deposit issued by some Australian banks.

With effect from September 2007, this list was expanded to include Australian dollar bonds issued by ADIs - including ADIs incorporated outside of Australia - that satisfied certain criteria. (By way of completeness, we note that with effect from October 2007, this list was also expanded to included certain residential mortgage-backed securities and asset-backed commercial paper instruments.)

2.2 Criteria

Australian-dollar denominated debt securities may be accepted by the RBA for repo if they are issued domestically by an authorised deposit-taking institution which holds an ES account at the RBA, provided that:

(a) the issuer is rated A3 or higher by all major credit rating agencies that rate it – and in any event by at least two such agencies;

(b) the securities are not subordinated;

(c) the securities are not structured – such as index-linked, embedded derivatives or variable rate interest margins;

(d) the securities are lodged and settled in Austraclear, and not traded as Euro entitlements; and

(e) the securities are not issued by itself or a related entity.

The rationale for this expansion was of course to assist banks with their liquidity – but the RBA has indicated that the expansion is to be permanent, rather than merely a temporary measure to assist during the credit crunch.

3. Mutual recognition

3.1 Legislative background

In December 2007, a new chapter (Chapter 8) was included in the Corporations Act 2001 (Cth) which provides in generic terms for the mutual recognition of the securities offered under the issuance regime of other jurisdictions. This was introduced through the passing by the Australian Commonwealth government of the Corporations (NZ Closer Economic Relations) and Other Legislation Amendment Act 2007 (Cth).

Notwithstanding the specific reference to New Zealand in the title of the enacting legislation, Chapter 8 is couched in generic terms, so it may be readily adapted to permit the mutual recognition of other countries – by being "activated" through regulation.

Nonetheless, the first mutual recognition regime introduced was as between Australia and New Zealand.

3.2 Australia/New Zealand mutual recognition regime

(a) Introduction

The Australia - New Zealand mutual recognition regime was established pursuant to the *Corporations Amendment Regulations 2008 (No.2),* which reflected an agreement reached between the parties under treaty in 2006.[89]

The regulations – and their New Zealand equivalent – established a mutual recognition scheme which allows an issuer of securities to offer securities, or interests in collective/managed investment schemes, in both countries using one disclosure document prepared under the regulations in its home country ie. from the point of view of a New Zealand issuer seeking to offer securities into Australia, compliance with the applicable New Zealand legislation – and some procedural Australian law requirements (such as the requirement for a specific warning statement) – will be sufficient to permit the securities to be offered in Australia.

The benefits are of course considerable costs savings – and thereby encouragement of trans-Tasman capital flows.

(b) Applicable legislation and regulatory guidance

[89] *The Agreement between the Government of Australia and the Government of New Zealand in relation to the Mutual Recognition of Securities Offerings.*

The actual instrument required to implement the legislation was regulations totalling approximately a dozen pages, which essentially lock into the Chapter 8 provisions of the Corporations Act (as described above), and make certain conforming amendments in relation to managed investment schemes and other matters.

Regulatory Guide 190 *Offering securities in New Zealand and Australia under mutual recognition* – which was published by the Australian Securities and Investments Commission (***ASIC***) in June 2008 – provides guidance as to the manner in which ASIC will administer this regime. (This regulatory guide is an essential reference for any persons contemplating such an issuance.)

(c) Initial requirements

The requirements for a New Zealand offeror seeking to issue securities into Australia are essentially as follows:

(i) Who can be an offeror?

The offeror must be incorporated under the law of New Zealand, or be a natural person resident in New Zealand, or be a legal person established under the law in New Zealand.

In addition, the issuer – and each person concerned with the management of the issuer – must not be:

- disqualified from being concerned in the management of the issuer under New Zealand law;
- be an undischarged bankrupt or having been convicted of certain offences;
- banned from ASIC from providing financial servicers or disqualified by a court under the Corporations Act;
- previously banned by ASIC from making a recognised offer.

(ii) What securities can be offered?

Shares, debentures and interests in managed investment schemes, and legal or equitable rights or interests in these products, or options in these products (see section 1200A of the Corporations Act).

(iii) What lodgements are required?

The issuer is required to lodge with ASIC a written statement of the intention to make the offer, including:

- any offer document required by NZ securities law;
- the constituent document of the issuer/scheme;
- details of any exemptions from the NZ securities laws that apply to the offer; and
- address for service of process in Australia.

These documents must be lodged at least 14 days before the day on which the offer is first made in Australia, and no later than the time the New Zealand Registrar of Companies is notified.

(iv) Are there any specific content requirements for the offer document?

The offer document must contain specific warning statements, as set out in the regulations.[90]

(d) Ongoing requirements

There are ongoing requirements as well:

(i) The offer

For so long as the offer is open to Australian investors, the offer must:

- remain a recognised offer in New Zealand;
- comply with NZ securities law; and
- be open to acceptance by persons on New Zealand.

(ii) The offeror

There are certain ongoing notification requirements to ASIC – such as in relation to amendments to the offer documents required under New Zealand securities law or supplementary offering documents.

(e) Sanctions for breach

Breach of the offering conditions has the following implications:

(i) breach of law (section 1200Q Corporations Act);

(ii) ASIC may make a stop order under section 1200N of the Corporations Act; and

(iii) ASIC may ban the issuer from making an offer under the regime for a specified period.

3.3 Further cross border mutual recognition

A key development to be watched is the extent to which this is the forerunner for additional mutual recognition regimes for securities offerings.

ASIC has recently issued a joint consultation paper with the Australian Treasury, entitled "Cross border recognition - Facilitating access to overseas markets and financial services". This paper was issued on 16 June 2008, with comments sought by 25 July 2008, and the intention of next steps to be proposed in August 2008. One of the key themes it explores is the extension of mutual recognition.

It notes that recent trends in international financial flows and regulatory developments highlight the need to address these issues. The paper refers to recent US and European developments, but it also discusses mutual recognition proposals in general. It notes that mutual recognition involves a party ceding part of its regulatory authority to a foreign regulator – and therefore requires extensive investigation.

[90] *Corporations Amendment Regulations 2008 (No.2).*

The aim of mutual recognition is stated to be:

- effective regulatory compliance and enforcement;
- market integrity;
- investor protection;
- reduced regulatory requirements; and
- encouraging the growth of Australia's domestic finance industry.

The paper notes that mutual recognition is founded on:

(a) joint commitment of the relevant governments and regulators to recognising the regulatory arrangements from the other country;

(b) substantial regulatory equivalence between Australian regulation and the relevant foreign regulation; and

(c) enhanced co-operation between ASIC and the relevant overseas regulator[91].

3.4 Australia/Hong Kong

On 7 July 2008, ASIC and the Hong Kong Securities and Futures Commission (SFC) signed a "declaration of mutual recognition" to facilitate the sale of retail funds to investors in each other's market.

The regime only applies in relation to managed investment schemes/collective investment schemes, and not other investment products at this stage.

The intention is to encourage investment flows between the different jurisdictions, and thereby facilitate more choice for Australian retail investors.

ASIC is to shortly issue a class order providing relief from certain product disclosure requirements. At the time of writing, this class order was not available.

4. GPS 120: "Assets in Australia"

Section 28 of the *Insurance Act 1973* (Clth) provides:

> "*A general insurer commits an offence if:*
> *(a) it does not hold assets in Australia (excluding goodwill and any other amount excluded by the prudential standards for the purposes of this section) of a value that is equal to or greater than the total amount of its liabilities in Australia….".*

The legislative intention behind this provision is essentially to ensure that general insurers maintain assets in Australia of a value that equals or exceeds the total amount of the general insurer's liabilities in Australia. Accordingly, an important consideration for insurers has been precisely what constitutes an "asset in Australia".

Kangaroo bonds were initially excluded as "assets in Australia" under Prudential Standard GPS 120 issued by the Australian Prudential Regulatory Authority (APRA). After much industry consultation and discussion, a revised

[91] Subsequent to the date of this paper, ASIC issues Report 134, "*Enhancing capital flows into and out of Australia*", which further explored a number of these issues.

form of GPS 120 was issued in June 2008, with effect from 1 July 2008 (there being no transitional arrangements, as the new criteria are an expansion of the prior position) – as described below.

(a) Policy perspective

As a preliminary matter, it is worth noting that the response paper issued by APRA in respect of GPS 120 acknowledges Kangaroo bonds as a source of quality assets, but references the policyholder protection perspective: that is, in the event of an insurer being wound up, APRA needed to be satisfied that the Kangaroo bonds would be considered assets in Australia by a court of law.

(b) *Prima facie* exclusion

Paragraph 11 of Prudential Standard GPS 120 describes the parameters of certain assets that are excluded from constituting "assets in Australia".

The terms of paragraph 11 are such that on its face, Kangaroo bonds would not constitute "assets in Australia", and therefore may not be included within the capital base of a general insurer.

(c) Carve-out for Kangaroo bonds

However, paragraph 12 provides that these exclusions do not apply in relation to Kangaroo bonds – which therefore may be included as "assets in Australia" – provided that they satisfy certain criteria as follows:

> "*Paragraph 11 does not exclude an interest of a locally incorporated insurer in a kangaroo bond from being an asset in Australia if all the following conditions are complied with:*
>
> *(a) the underlying bond is legally owned by Austraclear Ltd or a nominee for Austraclear Ltd and is lodged in the Austraclear system; and*
>
> *(b) the register recording legal ownership of the underlying bond is kept in Australia; and*
>
> *(c) the bond is created by a deed poll which is sealed, or deemed by its governing law to be sealed, and the deed poll is governed by Australian law and kept in Australia; and*
>
> *(d) the debt under the bond is expressed to be payable in Australia except where payment in Australia is prohibited by law (provided that if, at any time, such payment in Australia is prohibited by law, the debt under the bond shall be excluded from being an asset in Australia for so long as that payment is prohibited)."*

Accordingly, Kangaroo bonds may now be treated as "assets in Australia" by general insurers provided that:

(i) they are owned by Austraclear's nominees and are registered on Austraclear;

(ii) a separate register is kept in Australia;

(iii) they are created by deed poll under seal (or deemed to be sealed) that is governed by Australian law and kept in Australia;

(iv) the debt is expressed to be payable solely in Australia; and

(v) if there is a custodian between Austraclear and the insurer, the relevant account and any right the insurer has against the custodian are in Australia.

(d) Practical implications

These amendments remove a prudential "block" on investment in Kangaroo bonds by Australian general insurers. While the precise impact on demand is difficult to quantify, this can only improve the market appetite for these securities.

5. Covered bonds

Finally, it is worth noting for completeness that there has been recent confirmation of APRA's position with respect to covered bonds issued by ADI.

Covered bonds have been a significant feature of the European bank funding landscape for a number of years. However, they have traditionally not been permitted in Australia as a result of APRA's view of section 13A of the Banking Act 1959, which provides:

> *"If an ADI becomes unable to meet its obligation 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."*

These are essentially depositor protection provisions. In November 2007, by way of the amendments to the prudential standards necessary to implement Basle II regulatory capital requirements, APRA confirmed that it did not permit covered bonds to be issued by Australian ADIs. Australian Prudential Statement 120 states that:

> *"Covered bonds are not considered to be consistent with depositor preference provisions set out in the Banking Act and hence are prohibited."*

In late 2007 and early 2008, as a result of the well-documented issues within the securitisation industry, covered bonds had been the focus of renewed interest by ADI's, and there was widespread discussion as to whether there may be an appropriate structure that APRA would accept.

This has effectively been rejected by APRA, which issued a notice to ADIs in April 2008 which included a statement to the following effect:

> *"...the arguments advanced in support of such structures, many of which have been raised before, do not adequately address APRA's in principle objection to covered bonds…".*

Accordingly, it is unlikely there will be any issuance of covered bonds by Australian ADI's in the near future.

6. Conclusion

As may be seen, there have been some positive legislative and regulatory developments in Australia with respect to the sale of international capital markets instruments into Australia, notwithstanding the overall difficulties in the capital markets generally at that time.