Collateralised Debt Obligations: Australian and New Zealand legal and regulatory issues

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The 21st Annual Banking & Financial Services Law Association & Practice Conference

Hobart – 1 August 2004

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Retail collateralised debt obligations (CDOs). In most countries, these words make people frown or goggle. But not in Australia or New Zealand where the dynamic combination is called the trans-Tasman phenomenon. The volume of retail CDOs sold in this region is certainly drawing a lot of attention from overseas pundits interested in the rising trend. While retail CDO fans – originators, arrangers and buyers – are looking for further financial innovation, others – wholesale fund managers – anticipate loss of market share and potential danger.[1] *There are also some concerns about reputation risk for key participants involved in these transactions.*

Introduction

In this paper, we:

- consider the nature of CDOs and some typical CDO structures, both wholesale and retail;
- consider generally the role that CDOs and related credit derivatives play in risk management by banks, corporates and financial intermediaries; and
- outline certain Australian and New Zealand legal and regulatory issues that arise in the case of CDOs, with particular emphasis on listed, retail CDOs.

What's in a name – CLOs, CBOs and CDOs?

Early CDO transactions were called collateralised loan obligations (CLOs) and collateralised bond obligations (CBOs) and had their origins in the high yield non-investment grade loan and bond market of the late 1980s. As structures became more sophisticated and started involving single-name and portfolio credits on a static and managed basis, the CDO acronym emerged. A leading commentator characterised this development thus:[2]

> *There are two basic types of debt securitisation: a collateralised bond obligation ('CBO'), generally involving tradeable securities originated by an asset manager, and a collateralised loan obligation ('CLO'), generally involving loans with varying degrees of tradeability originated by a bank or other lender in the ordinary course of its business. The term...[CDO] covers both types and is generally used to describe a transaction involving both loans and tradeable securities. The structure may be static, where the assets are designated at the outset, or dynamic, where the asset manager has the right to substitute assets relatively freely, albeit subject to specified criteria."*[3]

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1 "Counting the Cost of CDOs", Insto, April 2004, 10.

2 Henderson, "Synthetic Securitisation, Part I: The Elements" (2001) 11 JIBFL 402, 402.

3 Where the CDO is dynamic, the skills of the manager are crucial in determining portfolio performance.

CDOs are accordingly often characterised as a form of debt securitisation,[4] but are probably more akin to credit securitisations, if the transfer of credit risk is the key rationale for doing this form of securitisation.

A conventional CDO structure

A CDO is, conventionally, the packaging of a cash-generating debt obligation or obligations into one or more portfolios meeting certain diversity and credit criteria. In this so-called "cash CDO" structure, these portfolios are transferred to a special purpose vehicle (the **SPV**) that finances that purchase through the issue of one or more tranches or classes of debt and quasi-debt securities to investors. The SPV secures its liabilities to the investors and certain other creditors by granting security over the portfolios of underlying assets.

Cash and synthetic CDOs

CDOs are today issued under a seemingly endless and bewildering variety of structures. Nevertheless, CDOs can, in broad terms, be classified into two main classes: *cash* or *synthetic*. The key difference between a cash CDO and a synthetic CDO is that, in a synthetic CDO, there is no transfer to the SPV of legal or equitable title to the underlying assets. Instead, a credit derivative is used to transfer the credit risk of the reference portfolio to the SPV. Put another way, a synthetic CDO is one in which the structure is driven by a credit derivative and in which only certain risks inherent in the reference obligations themselves are transferred.

In this paper, for simplicity's sake, we outline relatively straightforward CDO structures only.[5]

Cash CDO

A simple cash CDO typically takes the following form.

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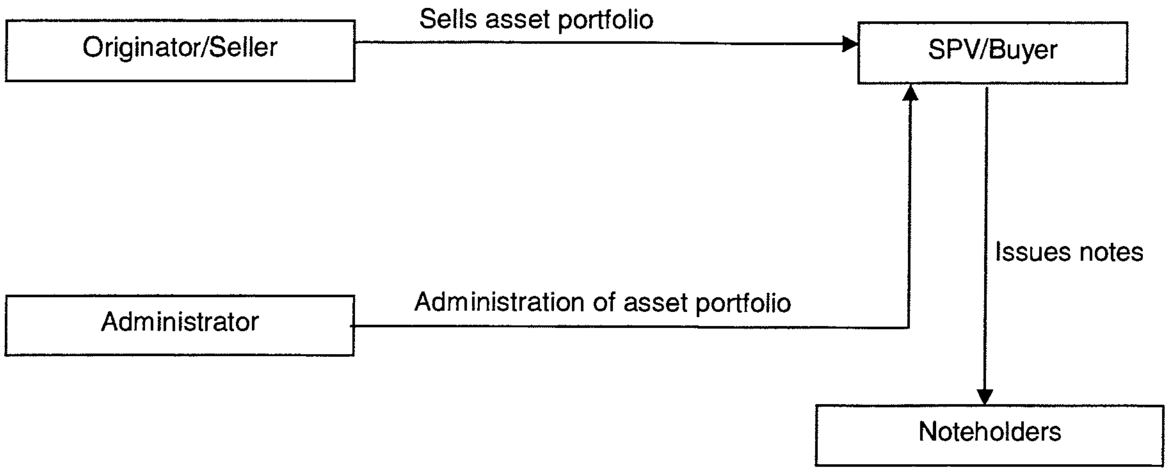
4 There is an ever-increasing literature on CDOs and, in particular, on synthetic CDOs. See, for example, Henderson, "Synthetic Securitisation Part I: The Elements", (2001) 11 JIBFL 402, "Synthetic Securitisation, Part 2: Reference Portfolio Risk" (2001) JIBFL 464 and "Synthetic and Securitisation, Part 3: Credit of the Issuer and the ISDA Master Agreement" (2001) 11 JIBFL 505; Handling, "Indebted to Securitisation", Finance 2001, 59; Forrester, "Why uncertainty could stall synthetic CDOs", IFLR, December 2003, 4; Choudry and Fabozzi, "Originating Collateralised Debt Obligations for Balance Sheet Management", Journal of Structured and Project Finance 2003, vol. 9, iss. 3, 32.

5 A CDO may also be what is referred to as a "balance sheet transaction" or as an "arbitrage transaction". See Henderson, "Synthetic Securitisation, Part 1: The Elements" (2001) 11 JIBFL 402. A transaction, such as the typical CLO, which is primarily motivated by capital, accounting or regulatory goals, is referred to as a "balance sheet transaction". Banks and insurance companies that wish to manage regulatory capital are the main originators of balance sheet CDOs. A CDO that is motivated by profiting from market anomalies, for example, between lower-rated, high-yielding assets and more highly-rated notes generated by tranching of risk, currency and/or rate conversion and other structural techniques, is referred to as an "arbitrage transaction". The economics of an arbitrage transaction may be based on the cashflow generated by the assets or their market value on liquidation. An originator may, for example, put together a reference portfolio that to some extent takes advantage of arbitrage opportunities arising out of wider credit default spreads on certain reference entities trading at levels (e.g., BB) that are not consistent with the then-current rating of those entities (e.g., BBB). Also, not all BBB credits, for example, trade at the same spreads. The originator profits from the arbitrage (the difference). Asset managers that wish to raise the assets under management are also typical originators of arbitrage CDOs. Interestingly, the arbitrage CDO market exhibited an 11 per cent. higher downgrade probability at the AAA-level than the corporate market in the period from 1996 to 2002: see "Squaring the circle", Structured Finance International, July/August 2003, 1.



Generally, a cash CDO is one in which the SPV acquires the underlying assets (the portfolio of loans or tradeable debt securities) for cash. The proceeds of the issue of securities is the cash that is used to purchase the underlying assets from the originator of the portfolio. The SPV takes credit risk on the underlying assets by virtue of that transfer. The cashflows from the assets are used to fund the SPV's obligations under the securities. Properly documented, a cash CDO provides funding for the originator/seller and removes the underlying assets from its balance sheet. For a bank originator, this may have favourable regulatory capital consequences; for both a bank and a corporate, it can improve return on equity.

Synthetic CDO

A synthetic CDO is a structured transaction in which the originator (typically, a bank or an insurance company) uses credit derivatives to transfer the credit risk on a specific asset or one or more specified asset portfolios to an SPV which, in turn, transfers that credit risk to note investors, without the originator selling the assets themselves. The asset portfolio may be loans, tradeable debt securities (including illiquid securities), derivatives and/or lines of credit.[6] In this paper, we refer to this asset portfolio as the *reference portfolio.* The reference portfolio can comprise a single *reference obligation* of a *reference entity* or many reference obligations of many reference entities.[7] The reference portfolio produces, in this sense, a synthetic set of risk and economic consequences.

A synthetic CDO may be *funded* or *unfunded.* In a funded synthetic CDO, the transfer of the credit risk to the SPV is effected by means of transfer of a credit-linked note.[8] In an unfunded synthetic

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6 For example, where the underlying reference portfolio contains CDO transactions, the synthetic CDO is known colloquially as a "CDO squared" (i.e., a CDO of CDOs). Some synthetic CDO reference portfolios also only comprise distressed debt obligations.

7 The nature of structured products is that they can be tailor-made to fit the investment and other needs of investors. However, although the so-called single name credit default market (i.e., one reference entity) is the volume product in the credit derivatives market, the portfolio product is generally regarded as the one that is potentially more important in terms of market growth and systemic credit risk transfer.

8 Colloquially, this type of credit-linked note is known as a "repack". For a good summary of credit-linked notes, see, generally, PricewaterhouseCoopers, *The Financial Jungle, A Guide to Credit Derivatives* (2001), chapter 4. A credit-linked note is a debt security under which the investor assumes the credit risk on both the issuer and a third party reference entity (i.e., the note is "linked" to these two credits). The credit-linked note is often listed and often incorporates ISDA credit derivative definitions. On maturity, the issuer will redeem the credit-linked note at par to the extent that no credit events have occurred in relation to the reference obligation of the reference entity. If there is a credit event, the amount paid to the investor

CDO, the transfer of credit risk is effected by means of a credit derivative such as a credit default swap and/or a total return swap.

Leveraged and full credit risk CDOs

Synthetic CDOs can in turn be classified into two main classes: *leveraged credit risk* and *full credit risk*. Under a leveraged credit risk CDO, only a percentage of the credit risk of the underlying reference portfolio is transferred to the SPV by way of the credit derivative. The originator typically incurs any credit losses over the level of protection it has bought under the credit default swap. The SPV in turn issues credit-linked notes to investors up the amount of the risk transferred under the credit default swap. Under a full credit risk CDO, the full credit risk of the underlying reference portfolio is transferred to the SPV by way of the credit derivative.

A typical unfunded synthetic CDO

An unfunded (in the sense only that there is no transfer of credit-linked notes to the SPV, although there is funding though the note investors' subscription) synthetic CDO under which credit-linked notes are issued by the SPV typically takes the following form.[9]

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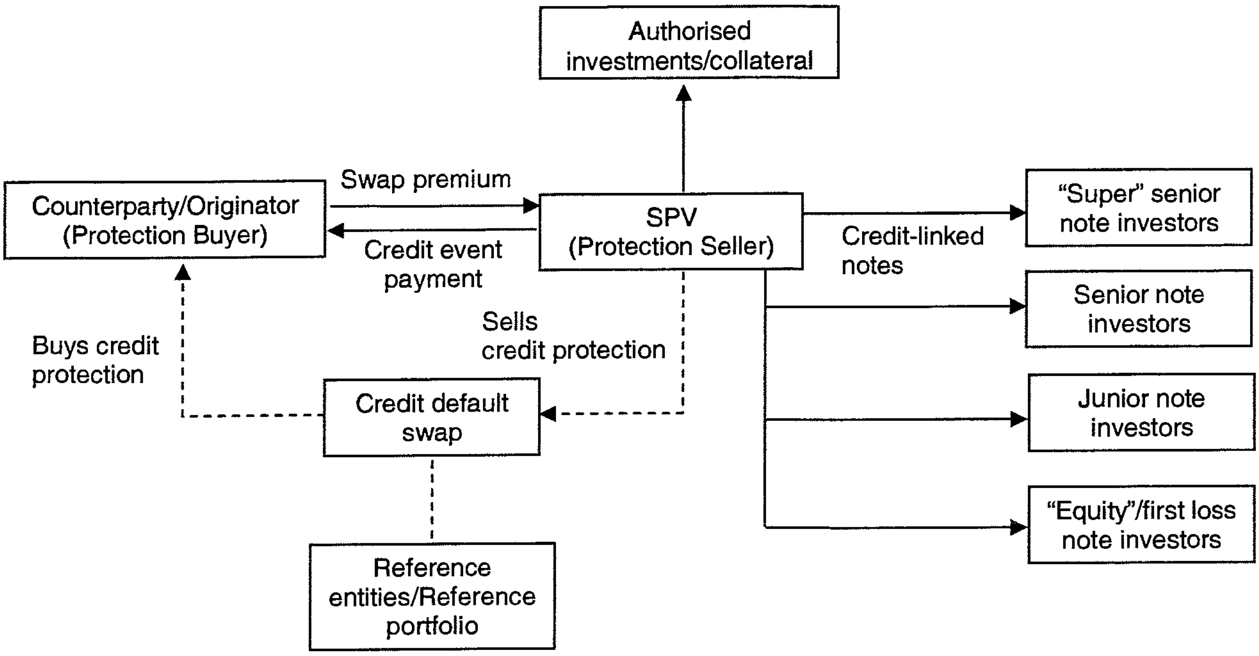
may be significantly less than par (reflecting the effect of the credit event on the value of the reference entity). For these reasons, a credit-linked note is often described as a medium-term note with an embedded credit default swap. The issuer of a credit-linked note is the equivalent of the protection buyer, and the investor the equivalent of the protection seller, under a fully funded credit default swap. The issuer pays a premium over the "market" funding rate for the note that is in effect the same as the premium in a credit default swap.

9 A common variation of a simple synthetic CDO transaction involves, say, a direct bank issuer rather than a SPV issuer. In this case, the bank issuer enters into a credit default swap directly with a note investor under which the bank, as protection buyer, buys credit protection from the note investor, as protection seller. The bank issuer may issue securities to the investor to fund the credit default swap. The interest and principal payments on the securities are direct obligations of the bank issuer. Typically, in this structure, the rating of any senior tranche of the securities is capped at the rating of the bank issuer. In this case, as in the case of an SPV issuer structure, the performance of the securities is linked to the performance of the reference entity or reference portfolio. If a credit event occurs under the credit default swap, settlement takes place through the write-down of the original note principal equal to the actual loss, less any first loss assumed by the bank issuer.



In this example, the SPV purchases the credit risk in the underlying reference portfolio from the originator by selling credit protection to the originator under the credit default swap (the SPV is the "protection seller") and the originator is the "protection buyer". The underlying reference portfolio may be referenced to a single reference entity or to a number of reference entities.

The SPV in turn typically transfers this credit risk to the investors by issuing credit-linked notes. The credit-linked notes may be issued in one or more tranches of descending seniority, the greatest risk being in the most junior, or first loss, tranche (sometimes called the quasi-debt or equity tranche).[10] The tranches often have a range of expected maturities depending on the risk profile of each tranche. These tranches are often rated.[11] The proceeds of the issue of credit-linked notes are typically used by the SPV to purchase highly-rated or "risk-free" securities as collateral.[12] The rating of the collateral is a limiting factor on the rating of the credit-linked notes. The cash flow from the collateral and from the premium payable by the originator (or protection buyer) under the credit default swap are used by the SPV to fund its obligations under the credit-linked notes. In this (unfunded) structure, the synthetic CDO does not provide funding to the originator.

What happens when a credit event occurs?

If a credit default swap is used by the originator to transfer its credit risk to the SPV, then what happens when a credit event occurs will depend on whether the swap is to be cash- or physically-settled. If, as is typically the case, it provides for cash settlement, then, if a credit event occurs under

10 Some CDO structures have had as much as 26 tranches. See *The Financial Times*, 17 December 2003. Generally, however, the so-called "super senior" tranche is the major driver of a synthetic CDO and makes up a very substantial portion of the whole synthetic CDO issue, particularly where all the reference portfolio is investment grade (perhaps, 80 per cent. to 95 per cent.).

11 The first loss tranche, or so-called "equity piece", is often unrated. Generally, the first loss tranche is only a very small portion of the whole synthetic CDO issue (subject to rating agency requirements, perhaps as low as 1 per cent. to 2 per cent. of the total issue size).

12 The credit-linked notes subscription moneys are typically invested in the collateral to allow the CDOs to achieve a higher rating than that of the originator.

the swap in relation to one or more of the reference obligations in the reference portfolio, collateral is typically sold to fund the payments required to be made by the SPV as protection seller under the swap. In that event, the market value of the most junior tranche of credit-linked notes falls. The size of the fall is dependent on the precise redemption mechanics of the various tranches. On maturity of the credit-linked notes, collateral is sold to meet, first, the redemption of the most senior tranche.

Why use synthetic CDO?[13]

Benefits to originator[14]

In balance sheet rather than arbitrage-driven CDO transactions,[15] the benefits to the originator include:

- If credit risk is transferred to the SPV by way of a credit default swap, then, by virtue of buying credit protection from the SPV, and by virtue of the SPV fully collateralising the swap with highly-rated or "risk-free" collateral it purchases with the proceeds of the credit-linked notes issued to investors,[16] the originator can transfer all the credit risk on the reference portfolio to the SPV. Hence, the originator typically has no SPV counterparty risk.

- A bank may have a portfolio of some thousands of loans and other credit risks. Depending upon the regulatory regime, corporate loans are relatively expensive in terms of allocated risk capital. The bank may, therefore, need to release capital. If credit risk is transferred to the SPV by way of a credit default swap, then the originator may obtain a reduced regulatory capital charge on its underlying exposure if the swap meets required regulatory conditions.[17]

- The originator can free up and reallocate economic capital and improve its return on risk-based capital by hedging credit risk that it finds unattractive (e.g., certain types of loans or credit concentrations or because the risk exposure does not generate the required return on economic capital).

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13 See, generally, PricewaterhouseCoopers, *The Financial Jungle, A Guide to Credit Derivatives* (2001), chapter 5, from which much of the following outline is taken.

14 In broad terms, synthetic CDOs are principally used by banks and insurance companies to *transfer credit risk* and to *manage economic and regulatory capital.* If, instead of a bank or insurance company, the synthetic CDO is driven by a portfolio manager, the structure provides arbitrage possibilities and increases the assets it has under management. However, this introduces risk exposure in relation to manager performance.

15 Balance sheet transactions often do not need all the features of a true synthetic deal (e.g., cash settlement). Arbitrage transactions, though, by their nature are synthetic. Many of the retail CDOs issued in Australia and New Zealand have been arbitrage-driven (in contrast, say, to Japan, where banks are more concerned about their balance sheets and regulatory capital). The arranger/originator uses the arbitrage created by its ability to price the credit default swaps for particular entities better than the rest of the wholesale and retail market. This motivation also increases the amount of leverage and the ultimate size of the underlying portfolio.

16 If, instead of a credit default swap, a credit-linked note is issued by the originator to the SPV, then the originator receives the cash proceeds at the outset (i.e., up front).

17 In Australia, credit weighting for synthetic CDOs is negotiated by the Australian Prudential Regulation Authority (**APRA**) on a case-by-case basis. By contrast, for other Australian securitisation products and in New Zealand (through the Reserve Bank of New Zealand), those Australian and New Zealand regulators currently follow general international practice (based on the 1988 Basle Capital Accord) and require risk capital to be held unless certain criteria demonstrating "clean break" of the credit risk between the bank originator and the SPV are met (for Australia, see APRA APS 120 for the relevant criteria, and for New Zealand, see the Reserve Bank of New Zealand's Capital Adequacy Framework Financial Stability Department Document BS2).

- If, however, credit risk is transferred to the SPV by way of credit-linked notes issued by the originator to the SPV, then, if the originator allocates the proceeds it receives from those notes as collateral against the reference credits it owns, it may obtain a low or zero regulatory capital charge against those assets.

- Selling rather than transferring credit risk to the SPV may be of benefit to the originator because transaction costs are thought to be lower using a derivative structure. However, while there is no sale of the underlying assets, it is still advisable in a synthetic CDO to undertake due diligence of the reference obligations and reference entities included in the reference portfolio.

- It is often not necessary to fund the "super senior" tranche.

- Taxation charges associated with the sale of the underlying reference portfolio may not be triggered by transferring credit risk only.

- In some jurisdictions, bank secrecy laws prevent a bank selling a loan. Using a credit derivative avoids these issues.

- Only a small percentage of a bank's portfolio of loans and other credits may trade in the secondary market. A synthetic CDO allows the originator to transfer credit risk to the SPV on illiquid or lower-rated assets as part of a diversified package with liquid and/or higher-rated assets. The illiquid or lower-rated assets may otherwise be difficult to sell or hedge individually.

- If the synthetic CDO is leveraged, the originating bank can get protection on a much larger reference portfolio, depending on the amount of credit risk transferred to the SPV and the expected loss on the reference portfolio.

- If the originator manages the SPV's collateral, it can generate income from margin created by substituting assets in and out of the collateral pool. Credit risk in the underlying portfolio can also be reduced by a dynamically-managed reference portfolio.

- Since a synthetic CDO does not require a sale of the underlying assets, true sale and recharacterisation issues do not arise.

- Some assets may have conditions preventing their securitisation or transfer.

- It is not necessary to obtain the consent of any reference entity in relation to a reference obligation.

- Generally, a synthetic CDO can be documented and launched more quickly than can a conventional securitisation transaction, in part because the so-called "ramp-up period" (the period prior to closing when the originator acquires assets to place in the reference portfolio) is shorter.

Benefits to investor

- Typically, the investor obtains an enhanced yield, compared to a cash CDO or classic securitisation. The enhanced yield has proved attractive in the recent low interest rate environment.

- The investor obtains access to risks associated with asset classes to which it would not normally have access.

- The investor can subscribe notes of differing tranches and, hence, accept risk suited to its investment risk profile.

- The investor does not have to record, monitor or collect interest and principal on the underlying reference portfolio or incur enforcement costs in relation to non-performing entities in the reference portfolio.
- The investor does not need to have or establish any relationship with the individual reference entities to which the underlying reference portfolio relates.
- The investor has no credit exposure to the originator, but instead (generally) is exposed to rated notes issued by the SPV.[18]
- If the CDO structure provides for substitution of reference obligations in the underlying reference portfolio, the investor has a lower level of prepayment risk.
- In a leveraged credit risk CDO, the credit risk is concentrated in the SPV and, hence, the return on the credit-linked notes issued by the SPV is greater.

Risks to originator

- Generally, a standard credit default swap does not replicate the credit exposure on a bond but the credit exposure on the issuer. Accordingly, there may be a mismatch of terms between the credit derivative and each reference obligation in the underlying reference portfolio (e.g., because of a difference between the loan covenants and the credit events in the credit default swap). If this occurs, the originator will not transfer all of its credit risk on the reference portfolio to the SPV.
- In an arbitrage transaction, if the pricing is wrong then the originator takes reputation and fee risk.
- The originator must minimise the risk of accounting and tax consolidation of the SPV with the originator.[19]
- The originator faces reputational and legal risk if one of its CDO structures collapses or if the disclosure is not sufficient.
- Because synthetic CDOs have large notional values and typically involve a large number of reference obligations and entities in the reference portfolio, the originator needs operationally robust systems to manage the reference portfolio.

Risks to investor

- The nature of a credit derivative is such that the protection buyer (i.e., the originator) is not required to suffer actual loss before the protection buyer (i.e., the SPV) is obliged to perform its side of the bargain. Therefore, the incentives for the declaration of a credit event in respect of the relevant reference entities are very much skewed against the investors (not least where the credit event may not cause the originator to suffer actual loss).
- In an unfunded synthetic CDO, the principal risk that the investor faces is the failure of one or more of the reference obligations in the underlying reference portfolio.[20]

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18 However, if the synthetic CDO is funded by way of an issue of credit-linked notes by the originator to the SPV, or the CDO is not collateralised, the rating of the notes issued by the SPV will normally be limited to the credit rating of the originator itself.

19 In principle, consolidation risk should be able to be avoided by appropriate structuring and documentation.

- Because credit risk in the underlying reference portfolio is concentrated in the lower ranked tranches of the credit-linked notes, an investor in those tranches faces a correspondingly increased credit risk.[21]

- Because the market value of the credit-linked notes is typically related directly to their rating, a downgrade, including possibly of the originator, affects their value.[22]

- There may not be a liquid secondary market for the credit-linked notes and those notes may be difficult to value.

- The credit-linked notes may be redeemable prior to their maturity because of the occurrence of a credit event under the credit derivative.

- Little due diligence may have been undertaken on the underlying reference portfolio, including of the reference obligations and reference entities, that the investor can rely upon.

- If the SPV collateralises the credit-linked notes, the collateral may be misappropriated or otherwise lose some of its value.

- The originator (or protection buyer) or any other counterparty to any interest rate swap which supports the cashflows (e.g., swapping the interest income on the collateral to cover interest on the investor's notes) may become insolvent. This risk is somewhat mitigated by the collateral but would probably cause the investor some loss.

- Managed portfolios also involve potential manager performance risk for investors.

Documentation of ISDA Master Agreement and credit derivative

One of the key legal issues in a synthetic CDO is the documentation of the ISDA Master Agreement and of the credit derivative. In broad terms:

- generally, because of the complications that inevitably exist in the underlying reference portfolio (e.g., loans that are originated across multi-jurisdictions, loans that are governed by different laws, non-standard documentation, etc.), the ISDA Master Agreement schedule and confirmation require substantial addition and amendment;

- specifically, in the case of the ISDA Master Agreement, as is the case in securitisations generally, many of the traditional events of default and termination events are not relevant to a transaction where the counterparty is an SPV; and

- specifically also, in the case of the 2003 ISDA Credit Derivatives Definitions (the **2003 Definitions**),[23] the risk of loss to the investors is driven by the credit events in the credit derivative; the broader those events, the broader the risk.

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20 In a funded synthetic CDO, of course, the investor is also exposed to the risk of failure of the originator.

21 If the synthetic CDO is leveraged, the credit risk is greater. The credit risk is already concentrated in the SPV because a much higher first percentage of losses will have been transferred into the SPV.

22 In particular, the first loss, or equity, tranche is driven by the high risk reference entities in the reference portfolio.

23 ISDA has published a number of supplements to the 2003 Definitions since they were published.

For these broad reasons, it is necessary in practice to analyse closely both and the events of default and termination events in the ISDA Master Agreement[24] and the credit events in the 2003 Definitions. It is not practicable in this paper to analyse in any detail the documentary issues that can arise in this context, not least because the variations required to the ISDA Master Agreement and to the credit derivative confirmation will in practice vary with the type of CDO structure and the type of credit derivative. Instead, we make some general observations in the following paragraphs.
In practice, variations are driven by the appetite for documentation risk of the originator, the marketing requirements of the credit-linked notes and rating agency concerns (since the issue is rated, not the issuer).[25] In broad terms, in a listed and rated synthetic CDO, the variations required in the ISDA Master Agreement are based on the following premises:[26]

- The SPV is a shell entity that, in effect, exists only to direct cash flows.

- The originator may be arranging the structure and, if not, will have had the opportunity to undertake due diligence on the SPV, will have received legal opinions and will be likely to have had the opportunity to provide significant input into the structure and the documentation.

- If the structure provides for termination payments, the obligation of the originator to pay over its gain (i.e., the ISDA confirmation provides for full two-way payments) is an asset which can be used to pay the credit-linked notes, while its right to be compensated for its loss makes it a competitor with the investors for the other assets of the SPV.

- Termination of the credit default swap usually necessitates redemption of the credit-linked notes and because of the operation of the limited recourse provisions, the sole source of payment is the assets of the SPV (including the swap).

- Rating agencies will be concerned to minimise the likelihood of early termination by reason of the occurrence of non-commercial, extraneous events and to maximise the likelihood that, on termination, the assets of the SPV are sufficient to repay the credit-linked notes.

ISDA Events of Default and Termination Events

Care must be taken to consider each of the ISDA Master Agreement Events of Default and Termination Events to determine their relevance and applicability to the particular CDO structure from the point of view of each counterparty to the swap (as well, of course, in a rated transaction, to the rating agencies[27]). For example, and very generally (using ISDA's terminology):[28]

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24 See, for example, Colley, "Synthetic Resecuritisations: The State of the Art" (2004) 03 JIBFL 96.

25 See Henderson, "Synthetic Securitisation, Part 3: Credit of the Issuer and the ISDA Master Agreement" (2001) 11 JIBFL 505, 507ff. Henderson's article contains a useful discussion of ISDA Master Agreement documentation issues in this context (albeit that the discussion must now be read in light of the 2003 Definitions).

26 Ibid., 508.

27 Generally, rating agencies address not only the default risk of a reference obligation in the reference portfolio but also other documentary and structural risks of the transaction. For example, because synthetic CDOs and credit-linked notes often incorporate Credit Events listed in the 2003 Definitions, Standard & Poor's has issued its own default definitions as a basis for its ratings and default studies. See Da Silva, "Synthetic Collateralised Debt Obligations and Credit-Linked Notes – A Fresh Look at Ratings Issues", Standard & Poor's, 15 July 2004.

28 See *Current Issues in Securitisation* (Sweet & Maxwell, 2002, ed. Borrows), 20-21.

- Failure to Pay is generally included since a payment obligation of the SPV under the swap ranks either *pari passu* with or, exceptionally, senior to its payment obligations under the credit-linked notes;

- Bankruptcy is generally not relevant since an SPV is structured to be bankruptcy-remote and the parties generally agree to a non-bankruptcy petition clause;

- Cross-Default and Default Under Specified Transaction are generally not relevant since the SPV does not generally have any other borrowings and the transaction depends on the credit quality of the reference portfolio and of the collateral;

- Credit Support Default is generally not relevant since the SPV does not generally have any third party credit support;

- Breach of Agreement and Misrepresentation are generally not applicable on the basis that the rating agencies do not assess the likelihood or ability of third parties to the transaction to perform and do not include the risk of non-performance when issuing ratings;

- Merger Without Assumption, Tax Event Upon Merger and Credit Event Upon Merger are generally removed because the SPV's corporate documents will generally prohibit mergers;

- Illegality is generally included because of the right of the Affected Party to transfer the swap;

- Tax Event is generally negotiated but the rating agencies will in any case ensure that its inclusion is subject to a satisfactory tax opinion to the broad effect that no withholding tax applies under current law and there is no pending legislation to create a withholding tax;[29] and

- Additional Termination Event is sometimes negotiated.[30]

Credit Events

For similar reasons, the Credit Events in the 2003 Definitions must also be considered carefully. This is a key issue in any CDO structure since these are the events that lead to a payment by the SPV as protection seller under the credit default swap and that, accordingly, reduce the assets of the SPV available to the note investors. Generally, therefore, investors in synthetic CDOs need to take considerable care to ensure that the terms of the credit default swap do not disadvantage them. For example, and very generally (using ISDA's terminology):

- where the reference portfolio comprises corporate reference entities, investors should seek to limit Credit Events to Bankruptcy, Failure to Pay and Modified Restructuring;[31]

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29 See Da Silva, "Synthetic Collateralised Debt Obligations and Credit-Linked Notes – A Fresh Look at Ratings Issues", Standard & Poor's, 15 July 2004, 9.

30 However, Standard & Poor's requires its deletion for rating purposes. *Ibid*, 9.

31 It is not possible in this paper to deal with the extensive debate that surrounded the inclusion of the definitions of Restructuring, Modified Restructuring (which, generally, is thought to be acceptable in the U.S. market) and Modified-Modified Restructuring (which, again generally, is thought to be acceptable in the European market) in the 2003 Definitions. See, for example, O'Connell and Boggiano, "Understanding ISDA's Credit Derivative Rules", IFLR, August 2003. In broad terms, and among other things, these three definitions provide different limitations on the maturity of the obligations that must be delivered upon the occurrence of a Credit Event, they require the deliverable obligation to be fully or conditionally transferable and do not allow bilateral obligations to trigger a Restructuring Credit Event. The key, summary, point is that the issue needs to be explored carefully in the particular context. Preferably, from the investor's point of view, Restructuring should not be a Credit Event at all. If, however, (full)

- Repudiation/Moratorium will generally be negotiated; and[32]
- accordingly, Obligation Acceleration (i.e., acceleration other than by reason of a failure to pay) and Obligation Default are generally not included.

Similarly, in a credit default swap, it is possible to limit the reference obligations of the reference entity that lead to a Credit Event to, for example, any Bond or Loan Obligation, as opposed to any Borrowed Money or Payment Obligation, of the reference entity. The 2003 Definitions contain many variations that can be negotiated in this context. Obviously, a narrower limitation affords greater protection to the SPV protection seller and, hence, to the note investors. Standard & Poor's, for example, does not accept Payment as a reference obligation for the reason that Payment may include commercial payment obligations (the example given is utility bills) or Borrowed Money (the example given is letters of credit and certificates of deposit).[33] Neither of these deliverable obligation categories are acceptable to Standard & Poor's on the basis that it is difficult to establish a recovery value for payment obligations other than Bonds and Loans.[34]

"Soft" Credit Events

A key issue is that the 2003 Definitions contain Credit Events that fall short of actual default, with the result that payments may be required by the protection seller under the credit derivative where the underlying reference entity has not itself defaulted. This means that the probability of loss on a synthetic CDO of a specific rating may be higher than for a conventional instrument of the same reference entity.

Investors in CDOs are rightly concerned about these so-called "soft Credit Events". For example, potential problems arise, from the investor's point of view, where a Credit Event that is stated to apply falls just short of insolvency or bankruptcy. If the ISDA documentation includes as a Credit Event that a reference entity is purportedly considering going into liquidation or otherwise making a bankruptcy filing, and that fact is in the public domain, then it would lead to a payment under the credit default swap by the SPV protection seller even if, over time, the reference entity is not actually put into liquidation or does not make a bankruptcy filing. Needless to say, an originator would take the view that the inclusion of a soft Credit Event is necessary as an early warning event in order to protect it.[35]

What are the concerns about retail synthetic CDOs?

It will be apparent from what we say above that synthetic CDOs are complex investments. It is also often said, therefore, that the risk profile of a synthetic CDO is complex enough for a professional investor to evaluate, let alone a retail investor, particularly where some retail investors are likely to regard the investment as belonging to a fixed income defensive asset class.[36] The leverage in a CDO structure means that it is possible to lose all of the investment, particularly an investment in a lower level first loss tranche. Among other things, it is said, a local retail investor cannot be expected to assess the creditworthiness of all the reference entities in the reference portfolio, many of which will

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Restructuring were to be used, in which case discounted assets could be delivered upon the occurrence of a Credit Event, investors should revisit the pricing of the CDO. Put another way, investors should be wary not to be caught by the "cheapest to deliver" option. It appears that a number of European investors have been affected by this.

32 In New Zealand, statutory management issues need to be considered in this context.

33 See Da Silva, "Synthetic Collateralised Debt Obligations and Credit-Linked Notes – A Fresh Look at Ratings Issues", Standard & Poor's, 15 July 2004, 9-11.

34 *Ibid*, 11.

35 See *Current Issues in Securitisation* (Sweet & Maxwell, 2002, ed. Borrows), 27-28.

36 See, for example, "Counting the cost of CDOs", Insto, April 2004, 10-15.

be overseas entities. It is often said, therefore, that the CDO market is part of a global trend that involves the transfer of risk away from the credit markets (banks) to the capital markets (investors). Also, the nature of a static CDO, where the reference portfolio is unmanaged, means that investors in each tranche must assume that they will hold the investment until, say, a five-year maturity, during which period there could be multiple downgrades of multiple reference entities in the reference portfolio. Some investors, therefore, prefer to invest only in dynamic CDOs where the reference portfolio is managed by a specialist collateral manager such that it is possible to trade in and out of reference entities' credits as, for example, the credit cycle changes.[37] For these reasons, some market participants believe that synthetic CDOs should not be sold to retail investors, or at least that only the higher-rated, most senior tranches should be sold to retail investors.

Unlike the United States, there is no regulatory body in Australia or New Zealand that assesses the merits of each CDO. In the United States, regulators allow the distribution of this type of investment product to qualified institutional investors only.[38]

Unsurprisingly, therefore, in Australia and New Zealand the focus is on the prospectus or other disclosure document.[39] Because of the complex nature of the risk disclosures required, and the requirement to describe in plain English the structure and risks in a manner that a retail investor can be expected to understand, the due diligence of the reference portfolio and the CDO structure, together with the prospectus preparation process, is intensive. The schedule to this paper contains a summary of various legal and regulatory issues that arise in Australia and New Zealand in this context in both a wholesale and a retail offering.

Are CDOs insurance?

Many credit derivative products are akin in economic terms to traditional insurance.[40] The questions therefore arise whether a synthetic CDO involves the carrying on of insurance business and whether the credit derivative can be characterised as an insurance contract. In brief, it is now generally accepted that credit derivatives do not involve the carrying on of insurance business and are not insurance contracts, for the following broad reasons:[41]

- In an insurance contract, there must be an "insurable interest" in order to be entitled to an insurance payment. This interest is, usually, ownership of or title to (or a similar right to) an asset. In a credit derivative, the protection buyer has no such interest in the assets in the reference portfolio.

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37 Ibid., 14.

38 Ibid., 15.

39 Interestingly, the Australian Securities and Investments Commission (**ASIC**) recently required Macquarie Bank to issue a supplementary prospectus explaining to investors that the latter's Generator CDO product should be described not as debentures but as unsecured notes. On a traditional view of the distinction between notes and bonds (as unsecured debt instruments) and debentures (as secured debt instruments), ASIC was correct. See *Australian Financial Review*, 14 April 2004, 33.

40 This issue has been dealt with at previous Banking & Financial Services Law Association & Practice Conferences Queenstown, June 2003). See also Henderson, "Credit Derivatives, Part 3: Selected Legal Issues" (1999) 5 JIBFL 193.

41 The following brief analysis is based upon an opinion obtained by ISDA in the United Kingdom. Very generally, the position should be the same in Australia and New Zealand. This issue arises principally in the case of credit default swaps (or credit default options). The issue is less in the case of credit-linked notes, and credit spread swaps and total return swaps. See also, Forrester, "Why uncertainty could stall synthetic CDOs" (2003) 12 JIBFL 24. The position is less clear in the case of synthetic resecuritisations: ibid., 25.

- The "insured" in a credit derivative (i.e., the protection buyer) is not required to suffer loss before the protection seller is obliged to perform its side of the bargain. In an insurance contract, the insured must suffer loss before it can make a claim.

- In a credit derivative, the reference entity is not a party to the transaction and the protection seller has no right of recourse to the reference entity.

Overview of Australian and New Zealand legal and regulatory issues

The principal legal and regulatory issues that arise in Australia and New Zealand in this context are generally familiar to equity and debt capital markets lawyers. Essentially, these issues involve an analysis of compliance with securities offering and disclosure laws and regulations.

In order to keep this paper within bounds, we have set out in the schedule a high level summary of relevant Australian and New Zealand legal and regulatory issues without reference to any particular CDO structure. We do not deal with taxation issues or anti-money laundering issues that arise in either jurisdiction. The schedule deals with both retail and wholesale, as well as listed and unlisted, transactions.

Concurrent Australian and New Zealand retail offering

In broad terms, the requirements in New Zealand for a concurrent Australian and New Zealand CDO issue, assuming due compliance with applicable Australian legal and regulatory requirements, are these:

- Provided the securities are offered in New Zealand concurrently with an offer of the same securities in Australia, the securities may be offered to retail investors in New Zealand without significant regulatory difficulty.

- An Australian issuer is, in principle, able to take advantage of an existing exemption notice, the Securities Act (Australian Issuers) Exemption Notice 2002 (the **Australian Issuers Exemption Notice**), which, in broad terms, enables the Australian issuer to offer the securities in New Zealand without being required to register a prospectus.

- The Australian Issuers Exemption Notice contains a number of conditions that must be complied with. These conditions are not, generally, onerous. Compliance with the Australian Issuers Exemption Notice does not, however, exempt the Australian issuer from the requirement to prepare a plain English, short-form, offering document for New Zealand investors (an investment statement).

- The Australian Issuers Exemption Notice provides that it is not necessary for the Australian issuer to appoint a local trustee for the holders of the securities where a trustee is appointed in Australia.

It may be possible for a New Zealand tranche of a concurrent offering to be made in New Zealand dollars (even where the Australian tranche is made in Australian dollars).

Summary of Australian and New Zealand Legal and Regulatory Issues

1. DISCLOSURE	AUSTRALIA	NEW ZEALAND
1.1 **What type of disclosure document may be required and when is a registered prospectus required for the issue of the CDOs?**	• A **prospectus** will be required to be lodged with the Australian Securities and Investments Commission (**ASIC**) if the CDOs are offered to "retail" investors. The Contents of a prospectus are discussed in paragraph 1.3. However, under s 1010A of the *Corporations Act 2001* (Cth) (**Corporations Act**), for as long as the CDO is a "debenture" and, therefore, a "security" as defined in the Corporations Act, disclosure in the form of a product disclosure statement (**PDS**) is not required to be given to prospective investors. (In general for other financial products, a PDS is required to be given to retail investors). • An **information memorandum** will be required for a wholesale issue. A wholesale issue is an issue to "sophisticated investors" or "professional investors". The contents of an information memorandum are discussed in paragraph 1.4.	• A **prospectus** will be required to be lodged with the Registrar of Companies if the CDOs are offered to "retail" investors, the contents of which are discussed in paragraph 1.3. • An **investment statement** (a short-form plain English summary of important aspects of the offer) will be required to be sent to each subscriber before subscription for a retail issue. • For a retail issue of debt securities, a trust deed (registered with the Registrar of Companies) and trustee are required. • For a wholesale issue, namely, an issue which falls within one of the safe harbours set out below, an **investment statement** or other short-form information memorandum is common, the contents of which are discussed in paragraph 1.4.
1.2 **What are the disclosure requirements for a wholesale issue?**	In summary, an investor can be classified as a **sophisticated investor** under section 708(8) if it falls within any of the following categories: • the minimum amount payable for the CDOs on acceptance of an offer by the investor is at least A$500,000;	In summary, the following safe harbours exist: • if each offeree is wealthy, or experienced in investing money or experienced in the industry or business to which the security relates (i.e., eligible persons); or

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	• the investor is certified by an accountant as having net assets of at least A$2.5 million or a gross income for each of the previous two financial years of at least $250,000 per year; or • the investor is a person who receives an offer through a licensed dealer who believes on reasonable grounds that they have previous experience in investing in securities which allows the investor to assess the merits of the investment. In summary, an investor can be classified as a **professional investor** under section 708(11) if each offeree is one or more of the following: • a financial services licensee (eg, broker/dealer); • a body regulated by APRA (eg, bank or insurance company); • a body registered under the *Financial Sector (Collection of Data) Act 2001* (eg, a finance or money market company); • a trustee of a superannuation fund, approved deposit fund, pooled superannuation trust or public superannuation scheme with net assets of at least A$10 million; • a person who controls at least $10 million; • a listed entity, or its related body corporate; • an exempt public authority;	• if each offeree is: ➢ a person whose principal business is the investment of money or who, in the course of and for the purposes of their business, habitually invests money (i.e., **habitual investors**); and/or ➢ required to pay a minimum subscription price of at least N.Z.$500,000 for the CDOs before allotment of those CDOs (i.e., the minimum subscription price exception). Whereas the operation of the eligible persons exception is mutually exclusive to the operation of the habitual investor exception, the operation of the minimum subscription price exception is *not*. Put another way, it is possible for: • some offerees to fall within the minimum subscription price exception; and • those offerees who do not fall within the minimum subscription price exception to fall within the habitual investor exception. A person is "wealthy" if an independent chartered accountant certifies that the person: • has net assets of at least N.Z.$2,000,000; or • had an annual gross income of at least N.Z.$200,000 for each of the last two

1. DISCLOSURE	AUSTRALIA	NEW ZEALAND
	• a body corporate, or an unincorporated body that (a) carries on a business of investment, and (b) for those purposes, invests funds received following an offer or invitation to the public, the terms of which provide for the funds to be subscribed to be used for those purposes.	financial years. For a person to be "experienced in investing money or in the industry or business to which the security relates" (as the case may be), the key requirement is for an independent "financial service provider" to be satisfied on reasonable grounds that the person to whom the offer is made, as a result of having experience of that kind, is able to assess: • the merits of the offer; • the value of the security; • the risks involved in accepting the offer; • that person's own information needs; and • the adequacy of the information given by the person making the offer. The key concept in relation to the habitual investor exception is "business". That is, an habitual investor is a person: • whose principal "business" is the investment of money; or • who, in the course of and for the purposes of his or her "business", habitually invests money. Persons who are likely to fall within the habitual

1. DISCLOSURE	AUSTRALIA	NEW ZEALAND
		investor exception include banks, finance companies, insurance companies, fund managers, advisers that engage in investment and securities trading activities, sharebrokers, building societies, certain government agencies, larger corporates (particularly those with a treasury function) and high net worth individuals whose principal business is the investment of money. Although a high net worth individual may also be an "eligible person" he or she must be categorised as a habitual investor because the "eligible person" exception is exclusive. An investment adviser whose principal business is the investment of money or who habitually invests money is, in principle, an habitual investor. Unlike some other jurisdictions, New Zealand's securities laws do not provide for a private placement exception by which an offer of securities may be made to less than a certain threshold number of offerees.
1.3 **What are the requirements for the content of a prospectus issued to retail investors?**	A prospectus issued to retail investors must contain all the information that investors and their professional advisers would reasonably require to make an informed assessment of the following matters: • the rights and liabilities attaching to the securities offered; and	Must contain all the information that investors and their professional advisers would reasonably require to make an informed assessment of the following matters: • the rights and liabilities attaching to the securities offered; and

1. DISCLOSURE	AUSTRALIA	NEW ZEALAND
	• the assets and liabilities, financial position and performance, profits and losses and prospects of the body that is to issue (or has issued) the shares, debentures or interests (see s 710(1) Corporations Act). In deciding what information should be included about a CDOs issue in order to meet the above requirements regard must be had to: • the nature of the securities and the body issuing the securities; • the matters that likely investors may reasonably be expected to know; and • the fact that certain matters may reasonably be expected to be known to their professional advisers (see s 710(2) Corporations Act). There are also a number of specific, technical disclosure requirements including those relating to certain payments to, or interests of, persons involved in the offer; listing details and prospectus lodgement requirements.	• the assets and liabilities, financial position and performance, profits and losses and prospects of the body that is to issue (or issued) the securities. There are also a number of specific, technical disclosure requirements that are not material for the purposes of this memorandum (for example, a description of the activities of, and any restrictions on, the issuing group, material contracts, pending proceedings and that a copy of the prospectus has been registered with the Registrar of Companies).
1.4 **What are the requirements for the content of an information memorandum provided to wholesale investors?**	• No mandatory disclosure requirements. However, material omissions and misleading and deceptive conduct (see paragraph 1.6) are prohibited. • The circumstances of the recipient are taken into account in determining whether a defective prospectus resulted in an investment decision that	• No mandatory disclosure requirements (provided that one of the safe harbours is satisfied (see paragraph 1.2). • There are de facto disclosure standards prohibiting misleading and deceptive conduct and material omissions which are

1. DISCLOSURE	AUSTRALIA	NEW ZEALAND
	would otherwise not have been made. Accordingly, an information memorandum directed at sophisticated investors who are experienced in structured transactions would not need to contain the same level of detailed, plain English explanations of a transaction such as a CDO as would a prospectus directed at retail investors. • However, there is a basic level of information which is material to any investor and which would need to be disclosed in any offer document, whether to wholesale or retail investors. • There is a developing market standard in Australia for information memoranda for CDOs which should be taken into account.	discussed in paragraph 1.6. • The circumstances of the recipient are taken into account in determining whether a defective prospectus led him or her into error. Accordingly, an information memorandum directed at sophisticated investors who are experienced in structured transactions would not need to contain the same level of detailed, plain English explanations of a transaction such as a CDO as would a prospectus directed at retail investors. However, there would be a certain basic level of information which is material to any investor and would need to be disclosed in any offering document, whether wholesale or retail.
1.5 **What potential liability arises for an arranger or issuer of CDOs in relation to a prospectus provided to retail investors?**	There is potential civil liability under section 729 where a person suffers loss or damage due to: • a misleading or deceptive statement in the prospectus; • an omission of the material required by the Corporations Act (as summarised above); or • a failure to disclose a new circumstance that has arisen since the prospectus was lodged with ASIC (by lodging and issuing a supplementary or replacement prospectus).	The Securities Act principally governs retail offers of securities in New Zealand. Potential civil liability arises under section 56 of the Securities Act where a person suffers loss or damage in reliance on an untrue statement in a registered prospectus. Potential civil liability also arises under section 57 of the Securities Act where a person suffers loss or damage in subscribing securities on the faith of an untrue statement purporting to be made by an expert in a registered prospectus.

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	Liability may also arise for other parties named with their consent in the prospectus (see paragraph 1.7).	Potential criminal liability arises under sections 58 and 59 of the Securities Act where: • a registered prospectus containing an untrue statement is distributed to the public; or • a registered prospectus is distributed to the public in contravention of the Securities Act . An "untrue statement" is one that is: • misleading in the form and context in which it is included; or • misleading by reason of the omission of a particular which is material to the statement in the form and context in which it is included. Potential liability arises if a statement were untrue, even if a statement elsewhere in the registered prospectus contradicts or qualifies the untrue statement. Accordingly, every statement made in a registered prospectus must be true. Other potential civil and criminal liability under New Zealand law which may also apply to a registered prospectus in relation to a retail offer of securities is discussed in paragraph 1.6.
1.6 **What potential liability arises in relation to an information memorandum**	• Civil liability arises where a person engages in conduct in relation to a financial product (such as notes or other securities) that *is misleading or*	• An information memorandum can be misleading or deceptive by the inclusion of inaccurate statements or by the omission of

1. DISCLOSURE	AUSTRALIA	NEW ZEALAND
provided to wholesale investors?	*deceptive or likely to mislead or deceive,* (primarily sections 1041E and 1041H). • An information memorandum can be misleading or deceptive by the inclusion of inaccurate statements or by the omission of information which makes what has actually been published misleading or deceptive. • The question of whether conduct is misleading or deceptive is an objective question determined by the court. A company which acted honestly and reasonably may nonetheless engage in conduct that is misleading or deceptive. However, the level of sophistication of the investor is relevant in considering whether conduct actually led the investor to make an investment decision which it would not otherwise have made. Conduct that may lead a less sophisticated investor into error may not have that result with a sophisticated investor. Such misleading and deceptive conduct can lead to both civil and criminal liability for a person involved in the contravention. • In the case of civil liability, a person who suffers loss or damage can claim damages against any person involved in the contravention (ss 1041E, 1041H and 1041I of the Corporations Act). • In the case where the person who engages in the relevant misleading and deceptive conduct does not	information which makes what has actually been published misleading or deceptive. Potential civil liability therefore arises under section 9 of the Fair Trading Act where an information memorandum contains a misleading or deceptive statement, or a statement that is likely to mislead or deceive. "Misleading or deceptive", in relation to a statement, includes omissions and half truths. The test of what is misleading or deceptive is objective having regard to the circumstances and the persons likely to be affected. Potential criminal liability arises under section 242 of the Crimes Act where an information memorandum, which is knowingly false in any material particular, is made, circulated or published with the intent to mislead or defraud investors. Potential civil liability arises under section 377(2) of the Companies Act where an information memorandum, containing a statement or report relating to the affairs of the issuer which is knowingly false and misleading in a material particular, is made or furnished to a person to whom the offer of securities is then made. Potential civil liability arises at common law where an information memorandum contains a false or misleading representation or an untrue statement.

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	care whether the statement made is true or false or that person knows, or ought reasonably to have known, that the statement or information is false in a material particular or is materially misleading, that person could be liable for a fine of up to $22,000 or imprisonment for 5 years. In the case of a corporation, the relevant fine is up to A$110,000 (see sections 1041E, 1311(1), and Schedule 3 item 310C of the Corporations Act).	
1.7 **Who is potentially liable for a defective prospectus provided to retail investors?**	An arranger of a CDO program, is likely to have potential liability if the prospectus is defective, as set out below. Mitigating factors and defences are discussed in paragraph 1.9. The persons who have potential civil liability are: • the entity making the offer; • the directors, or proposed directors named in the prospectus, of the entity making the offer; • the underwriter to the issue named in the prospectus with consent; • any person named in the prospectus with their consent as having made a statement that is included in the prospectus, or on which the statement made in the prospectus is based; • a person who makes, or is involved in making misstatements in or omissions from disclosure documents.	The originator or arranger of the CDO, is potentially liable as a promoter under the Securities Act if the registered prospectus is defective. Defences are discussed in paragraph 1.9. Under section 56 of the Securities Act, the directors of the issuer (current and future, if named in the registered prospectus) and every promoter of the securities are potentially civilly liable to compensate for any loss or damage suffered by reason of an untrue statement in the registered prospectus. Under section 57 of the Securities Act, every person who consents to the distribution of a registered prospectus that contains an untrue statement purporting to be made by him or her as an expert is potentially civilly liable to compensate for any loss or damage suffered by reason of the untrue statement. Under section 58 of the Securities Act, the

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	(See s 729 Corporations Act). The persons liable under (i), (ii) and (iii) above are potentially liable for the accuracy of the whole of the prospectus. The persons referred to in paragraph (iv) above are only liable for the relevant statements made by them. A person involved in a contravention under paragraph (v) above is liable to the extent that the loss or damage is caused by that contravention. Each of the above persons is required to notify the offeror if they become aware of a material misstatement in or omission from the prospectus. A person is involved in a contravention for the purposes of (v) above if the person has been involved in **relevant conduct**, as follows: • aided, abetted, counselled or procured the contravention; • induced, whether by threats or promises or otherwise, the contravention; • been in any way, by act or omission, directly or indirectly, knowingly concerned in, or party to, the contravention; or • conspired with others to effect the contravention. (See s 79 Corporations Act). An arranger of a CDO is likely to fall within paragraph (v) above if the prospectus is defective as the arranger	directors of the issuer (current and future, if named in the registered prospectus) are potentially criminally liable for distribution of a registered prospectus that includes an untrue statement to: • on conviction on indictment, imprisonment for up to 5 years or a fine of up to N.Z.$300,000; or • on summary conviction, imprisonment for up to 3 months or a fine of up to N.Z.$300,000. Under section 59 of the Securities Act, the issuer, the directors of the issuer (current and future, if named in the registered prospectus), every principal officer (at the time of the contravention) and every promoter of the securities are potentially criminally liable for distribution of a registered prospectus in contravention of the Securities Act to, on summary conviction, a fine of up to N.Z.$300,000. A "director" includes not only a person who has that title formally, but also a person who occupies the position of a director irrespective of his or her title. A "promoter" is a person (other than a professional advisor) who is instrumental in the formulation of a plan or programme pursuant to which securities are offered to the public in New

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	usually has a large degree of involvement in the preparation of the prospectus..	Zealand. If a promoter is a company, the directors of that company will also be promoters. Other potential civil and criminal liability under New Zealand law which may also apply to a registered prospectus in relation to a retail offer of securities is discussed in paragraph 1.8. The originator or arranger of a CDO will likely be a "promoter" if it is involved in the preparation of the registered prospectus. If it is not so involved, advice will be required whether its role is such that it is a "promoter".
1.8 **Who is potentially liable for a defective information memorandum provided to wholesale investors?**	An arranger of a CDO is potentially liable if the information memorandum is defective, as set out below. Mitigating factors are discussed in paragraph 1.10. The persons potentially liable for making a false or misleading statement (s 1041E) or misleading and deceptive conduct (s 1041H) (see paragraph 1.6 above) are: • the issuer; • anyone who causes or authorises the issue of the information memorandum; • a person who was involved in the contravention by their relevant conduct (see s 79 Corporations Act and paragraph 1.7 above).	The originator or arranger of the CDO is potentially liable (where applicable, as set out below) if the information memorandum is defective. Under section 9 of the Fair Trading Act , the person who, in trade, makes a statement in an information memorandum that is misleading or deceptive, or is likely to mislead or deceive, is potentially civilly liable. Under section 242 of the Crimes Act, every promoter, director, manager or officer of the issuer who makes, circulates or publishes (or concurs in doing so) an information memorandum, which he or she knows to be false in any material particular with the intent to mislead or defraud investors, is potentially criminally liable. Under section 377(2) of the Companies Act, every director or employee of the issuer who

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		makes or furnishes (or authorises or permits to do so) an information memorandum, which contains a statement or report relating to the affairs of the company that is false and misleading in a material particular knowing it to be false or misleading, to a person to whom the offer of securities is then made is potentially civilly liable. Under contract law, the party who makes a false or misleading representation or warranty or an untrue statement in an information memorandum is potentially civilly liable.
1.9 **How to reduce risk in relation to a prospectus provided to retail investors.**	• Establish one of the "due diligence" defences to both civil and criminal liability. In summary, this requires the arranger, the issuer, and any other potential defendant who falls within the categories listed in paragraph 1.7 above to be able to prove that they made *all inquiries (if any) that were reasonable in the circumstances* and that after doing so, believed on reasonable grounds that the statement was not misleading or deceptive, or in the case of an omission, that there was no omission from the prospectus in relation to that matter. • Depending upon the proposed distribution structure, an arranger could attempt to restrict its role in the preparation of the prospectus so that it is not one of the persons potentially liable under (i), (ii) or (iii) of paragraph 1.7 above. However, by the very nature of its role, it will be difficult for an	Generally, the originator, the directors of the issuer, every promoter and any other potential defendant discussed in 1.7 should establish one of the "due diligence" defences to civil and criminal liability under the Securities Act. A "due diligence" defence under the Securities Act means that a person is capable of proving that he or she: • made all inquiries (if any) that were reasonable in the circumstances to verify the truth of a statement in the registered prospectus; and • after making those inquiries, believed, on reasonable grounds, that the statement in a registered prospectus was true up to the time of subscription for the securities (the

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	arranger to disassociate itself from the prospectus sufficiently to remove all potential risk and it is likely that it will fall within (v) of paragraph 1.7 above.	"reasonable grounds" defence). • Proper due diligence enquiries increase the likelihood of the availability of a "due diligence" defence. Other protections from liability under New Zealand law which may also apply to a registered prospectus in relation to a retail offer of securities are discussed in paragraph 1.10.
1.10 **How to reduce risk in relation to an information memorandum provided to wholesale investors.**	• There is no statutory due diligence defence available. A person cannot avoid liability for misleading and deceptive conduct, but a person may be fairly excused for the contravention under section 1041H (misleading and deceptive conduct, see paragraph 1.6 above) if, having regard to all the circumstances, the court is satisfied that the person has acted honestly and, having regard to all the circumstances, that person ought fairly to be excused for the contravention. • Proper due diligence inquiries designed to ensure that the information memorandum does not contain false, misleading or deceptive information may mitigate damages for the breach of section 1041H, but cannot be relied on as a complete defence to all liability.	• There is no statutory due diligence defence available. • A person cannot exclude himself or herself from liability for any false, misleading or deceptive conduct. • Proper due diligence enquiries designed to ensure that the information memorandum does not contain false, misleading or deceptive information may mitigate damages, but cannot be relied on as a complete defence to all civil and criminal liability.

2. LISTING	AUSTRALIA	NEW ZEALAND
2.1 **Primary threshold requirements for listing**	• Must seek quotation of debt securities only. • Must be a public company limited by shares, a government borrowing authority, a public authority, or an entity approved by the Australian Stock Exchange (ASX). We would expect the issuer to be a public company limited by shares. • Must have net tangible assets of at least $10 million or all of the following must be satisfied: - parent entity must have net tangible assets of at least $10 million; - Securities must be unconditionally and irrevocably guaranteed by parent; and - parent must give an undertaking to provide certain financial statements to ASX for release to the market. • The ASX has granted waivers of the net tangible assets requirements in a number of recent CDO transactions on an ad hoc basis and is currently formulating guidelines for waiving this rule for CDOs. • Must appoint a person to be responsible for communicating with ASX in relation to listing rule matters.	Any person may apply to the NZX for listing either: • with the NZX as the home exchange; or • with a Recognised Stock Exchange as the home exchange, if that person is domiciled or incorporated outside New Zealand and listed on a Recognised Stock Exchange (eg, any full member of the *Federation Internationale des bourses de Valeurs*). • as a Dual Listed Issuer (i.e. an issuer incorporated in Australia and in respect of which both NZX and ASX are home exchanges). The application for listing must be made through a market participant accredited and designated by NZX to bring new offers of securities to a market provided by NZX (i.e. a Primary Market Participant). Generally, an applicant will not be considered for listing unless the anticipated market value (as estimated by the NZX) of the securities to be quoted is at least N.Z.$5 million.
2.2 **Quotation requirements**	• The terms of the CDOs must in ASX's opinion be fair and equitable.	A listed issuer or a applicant for listing may apply to the NZX for a class or classes of its securities to be quoted on the NZSX or NZDX.

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	• Must provide ASX with a document that sets out the terms of the CDOs ie the trust deed. • The CDOs must meet ASX's settlement requirements. These relate to the equities clearing house known as CHESS. • The aggregate face value of the CDOs must be at least A$10 million.	Separate application must be made for each class of securities and through a Primary Market Participant. Certain information must be submitted to the NZX (eg, details of the security, evidence that the Primary Market Participant sought assurance from the NZX that authority to act has not been withdrawn, a draft offering document (including a timetable of all relevant dates), any advertisement proposed to be issued before quotation) or any other information or documents that the NZX may request.. Generally, a class of securities will not be considered for quotation unless those securities are held by at least 500 members of the public holding at least 25% of securities of that class issued, with each of those members of the public holding at least a prescribed minimum holding.
2.3 **On-going requirements – Corporations Act**	• Quarterly reports for the trustee which are also lodged with ASIC. • Provide the trustee with the details of any charge created.	No ongoing listing requirements under the Companies Act.
2.4 **On-going requirements – Listing Rules**	• Must immediately tell ASX if it 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 CDOs. • May not refuse to register a transfer of the CDOs	A listed issuer has a fundamental obligation to ensure that the market is kept fully informed. Information to be made public must first be released to the NZX prior to its public release. A listed issuer must disclose the following

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	and may not charge a fee for registering transfer documents. • Each year must provide a copy of audited annual accounts. • Must provide a fresh copy of the trust deed if it is amended. • Must tell ASX of any change of directors, secretary or auditor. • Each year must advise ASX of the aggregate face value of its quoted debt securities on issue. • A timetable relating to interest rate payment applies – the record date must be 7 calendar days prior to the actual payment date.	information to the NZX: • all information which a reasonable person would expect, if generally available to the market, to have a material effect on the price or value of the CDOs; • its annual and half-year financial results; • its annual and half-year reports; • any proposed change in the general nature of the business of the listed issuer or its group; • details of certain material disposals or acquisitions; • details of any benefits (eg, distributions, interest, etc.) at least 10 business days before the record date; • a copy of every notice or communication given to investorsand any stock exchange other than the NZX; • any proposal to sub-divide or consolidate securities, or to issue equity securities, whether they are to be quoted or not; • any proposal to amend conditions of the CDOs; • any change in directors or auditor of the listed issuer; and

2. LISTING	AUSTRALIA	NEW ZEALAND
		• any credit ratings of the listed issuer or any guaranteeing entity of the issuer. Every director of a listed issuer must disclose to the issuer and the NZX the nature of any relevant interest in the CDOs. The Securities Markets Act extends the NZX Listing Rules disclosure requirements so that they also apply to "officers" (i.e., senior executives) of the listed issuer. The disclosure obligations under the NZX Listing Rules and the Securities Markets Act will continue to apply to directors and officers of the listed issuer for 6 months after they cease to hold office. The listed issuer will be required to keep an interests register containing details of disclosures made by directors and officers under the NZX Listing Rules and the Securities Markets Act.

3. LICENSING REQUIREMENTS	AUSTRALIA	NEW ZEALAND
3.1 **Does the issuer of the CDOs require an Australian financial services licence (AFSL) or a similar licence in New Zealand?**	The primary activities of an issuer will be: • issuing the CDOs; • issuing an information memorandum or a prospectus; • entering into derivative transactions (a credit default swap, possibly an interest rate swap and/or	No financial services licence is required.

3. LICENSING REQUIREMENTS	AUSTRALIA	NEW ZEALAND
	currency swap(s)). **Regulation of "dealing"** Because a CDO will usually be classified as a "debenture" under s 9, and therefore, by virtue of s 761A be a "security", a CDO will usually be a "financial product" subject to the licensing and disclosure requirements of Chapter 7 of the Corporations Act. Issuing of a CDO is, therefore, within the concept of "dealing in a financial product" (see s 766C Corporations Act) which in turn is a "financial service" for which the relevant entity performing the service must have an Australian Financial Services Licence (**AFSL**) from ASIC. There are, however, a number of structuring alternatives where an AFSL will not be required. Each of these is set out below. **Intermediary authorisation** There is an exemption to the requirement to hold an AFSL for the issue, variation or disposal of a financial product where there is an arrangement (an "intermediary authorisation") between the product provider and an AFSL holder where the licensee makes offers to arrange for the issue etc of the financial products and the product provider issues the product in accordance with such offers if they are accepted (see s 911A(2)(b) Corporations Act). The offers to arrange must, naturally, be covered by the conditions of the AFSL held by the arranger. **Self-dealing exemption**	

3. LICENSING REQUIREMENTS	AUSTRALIA	NEW ZEALAND
	An AFSL is not required where the entity is dealing in its own securities (ie, issuing its own notes) (see s 766C(4)(c)). Note, however, this exemption specifically does not apply where the entity carries on a business of investment in securities or other interests and in the course of carrying on that business invests funds subscribed (directly or indirectly) following an offer or invitation to the public on terms that the funds collected would be so invested (see s 766C(5)). For most purposes, therefore, this exemption will be unavailable for CDO issues. **Class Order 03/1098** In late 2003, ASIC released a temporary (until 24 September 2004) exemption to the requirement for licensing (Class Order 03/1098) pending what is hoped to be a more permanent solution for the securitisation industry. The Class Order exempts a "securitisation entity" (see below) from the requirement to hold an AFSL where the following conditions are met: • The entity issues securitisation products that are "financial products" in the ordinary course of business of the securitisation entity, and the issue is either to a person (an intermediary) who holds an AFSL for the purpose of on-selling the securitisation product, OR the issue is arranged by a person who holds an AFSL where, prospectus or PDS disclosure to retail clients is not required. • The securitisation entity deals in (but does not issue)	

3. LICENSING REQUIREMENTS	AUSTRALIA	NEW ZEALAND
	financial products that are not derivatives or foreign exchange contracts, and the dealing is entered into in the ordinary course of business of the entity. • The securitisation entity either deals in derivatives or foreign exchange contracts or both, where the service does not involve "making a market" for those products, and the dealing is entered into for the purpose of managing financial risk that arises in the ordinary course of business of the securitisation entity, and where the counterparty for the dealing is a "wholesale client". • The service is providing a custodial or depository service in relation to financial products held by the securitisation entity in the ordinary course of its business. • A "**securitisation entity**" is a body corporate (note, not a trust) that: • carries on a business that consists of managing by way of securitisation some or all of the economic risk associated with assets, liabilities or investments (whether the risk is assumed or created itself); • is an insolvency-remote special purpose entity according to the criteria (applicable to its circumstances) of an internationally recognised rating agency (whether or not a rating agency has determined that the body meets those criteria); and	

3. LICENSING REQUIREMENTS	AUSTRALIA	NEW ZEALAND
	• it raises all or substantially all its funds by issuing securitisation products on terms that the funds raised would be applied in the business of managing economic risk by securitisation transaction(s). There are obvious limitations in this definition including the fact that only an incorporated securitisation vehicle, not a trustee vehicle, is not exempted from the licensing requirements, and the definition may not cover warehouse arrangements. **Regulation of "advising"** Providing "financial product advice" also requires an AFSL. "Financial product advice" is a recommendation or a statement of opinion or a report of either of those things that is intended to influence a person making a decision in relation to a particular financial product or could reasonably be regarded as intending to have such influence. Some points to note in relation to an issuer giving financial product advice are: • The issue of an information memorandum by the issuer will not require an AFSL either, provided that (i) the issuer provides the document to an entity that is appropriately licensed under an AFSL and that entity circulates the document to potential investors; and (ii) the information memorandum or prospectus does not constitute "personal advice". (See s 766B(3)(4) Corporations Act). • "Personal advice" is advice given in relation to a	

3. LICENSING REQUIREMENTS	AUSTRALIA	NEW ZEALAND
	financial product such as the CDOs which is given or directed to a person (including by electronic means) in circumstances where: (a) the provider of the advice has considered one or more of the person's objectives, financial situation or needs; or (b) a reasonable person might expect the provider to have considered one or more of those matters. (See s 766B(3) Corporations Act). The giving of personal advice requires further disclosure in the form of a Statement of Advice. It is important that an issuer include appropriate disclaimers in any disclosure document in support of the fact that the issuer is not giving personal advice.	

3. LICENSING REQUIREMENTS		AUSTRALIA	NEW ZEALAND
3.2	**What additional disclosure might be required to comply with financial services regulations?**	• If an offer is made to a "**sophisticated investor**" or a "**professional investor**" (see paragraph 1.2 above) it will be an offer to a wholesale client for the purposes of the Corporations Act. • If the offer does not fall within those exemptions, a retail prospectus would be required as described in paragraph 1.2 above. • For a retail issue, a dealer appointed by the SPV would need to provide its customers with a Financial Services Guide (general information about the dealer and all of the services it provides) and a Statement of Advice (addressing the individual needs of the customer where personal advice has been given).	In New Zealand, there is no equivalent additional disclosure required to comply with any financial services regulations.

4. DISTRIBUTION ARRANGEMENTS		AUSTRALIA	NEW ZEALAND
4.1		Distribution or dealer agreements would typically include provisions: • requiring the dealer to comply with Australian and applicable overseas selling restrictions; • confirming that the dealer has conducted its own suitability ("know-your-customer") and anti-money laundering checks; and	The Australian issues would apply equally in New Zealand. For example: • if an offer of securities were to be made at a wholesale rather than a retail level, it would be necessary to include an appropriate New Zealand selling restriction and to impose liability on any local dealer or distributor for breach of that selling restriction; and

4. DISTRIBUTION ARRANGEMENTS	AUSTRALIA	NEW ZEALAND
	• requiring the dealer to purchase the CDOs as principal and not agent.	• if there is a local distributor or dealer, it would be advisable to ensure that that distributor or dealer complies with all local laws, including, particularly, money laundering compliance, etc.