

Property Fund News September 2010

In a recent edition, we commented that green shoots were appearing and welcomed the apparent improvement in market sentiment. Unfortunately, these shoots do not appear to be growing as quickly as we might like. It would seem industry participants are more confident about the market, but still remain cautious. Fears of a double-dip recession, the ineffective Federal Government and a two-speed economy that appears likely to result in higher interest rates are just some of the factors slowing the sector's recovery.

Well-managed property funds with transparent structures, great assets and strong tenants on long term leases will always be an attractive investment option in a diversified investment portfolio, but raising equity from the broader investor public appears difficult unless the issuer has a great track record or its own distribution capabilities. Having said that, wholesale investors seem willing to invest in funds acquiring distressed assets or those developing or repositioning property. Typically, these are not big capital raisings and the investors have some comfort in relation to their exit.

We are also talking to clients about mortgage funds or, more specifically, special purpose debt funds. To the extent the major banks are prepared to lend, their loan-to-value covenants have reduced, which means there is a clear demand for a second tranche of debt. First mortgage opportunities are also available for those with cash to lend. There are top quality developers with great projects currently in need of debt funding which means this sector of the property finance industry should recover quickly. The demand is there, we just need to solve the supply.

Solving the supply side of the equation may, to a large extent, be impacted by the Federal Government's reform of the financial planning industry. At present, the reform agenda is not clear but rest assured, we are liaising with the Federal Government in relation to these key reforms and many others.

We trust you derive value from this edition of *Property Fund News*.

Regards

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Financial advice reforms and shorter PDSs—where are we at now?

The story until now

We reported earlier this year on the Federal Government's proposed major reforms to the regulation of financial advice, as well as on the introduction of the long talked about shorter product disclosure statement (PDS) regime.

The reforms to advisor remuneration structures and associated matters were announced by the Labor Government back in May 2010, well before the somewhat ill-fated Federal election.

The simpler PDS regulations came into force in June 2010. These only apply to so-called "simple managed investment schemes" (and there is a two year transition period). Property funds are excluded but most property securities funds will be caught.

So, with the election finally resolved and a "new" minority government in place in Canberra, what is the future for the financial advice reforms and for property fund PDSs?

PDSs

Fund managers with products that are caught by the new simpler PDS regulations will need to keep 22 June 2011 in mind because it is from this date the regulations begin to apply to all new PDSs and existing PDSs requiring amendment. All PDSs in the market on 22 June 2012 must comply. As noted earlier, the shorter PDS regime does not apply to direct property funds.

The Financial Services Working Group, which was involved in the design of the new regime, has now been disbanded. However, after the regulations came in, the Government indicated that Treasury and ASIC, together with industry, would continue to work on simplifying disclosure documents. It is therefore quite possible that some time into the future, we will see moves towards a mandated simplification of PDSs for property funds and other funds not captured by the new law.

However, there has been no indication on timing; so for now, the existing longer-form PDS regime continues to apply to property fund PDSs and it is just a matter of "watch this space".

We will keep you informed of any developments in these two important areas, each of which will have a big impact on the property funds industry and how it distributes its products.



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Octaviar High Court decision

In early September 2010, the High Court handed down its much anticipated decision in *Public Trustee of Queensland v Fortis Credit Corporation (AUS) Pty Ltd* (the Octaviar decision). The High Court unanimously approved the decision of the Queensland Court of Appeal, thereby putting an end to the saga which began with the Supreme Court of Queensland's first instance decision in early 2009.

The High Court's decision ends the uncertainty in relation to registered charges that define the secured obligations by reference to the term "Transaction Documents".

For financiers, this will mean they can breathe a sigh of relief in relation to existing facilities which used the "Transaction Documents" mechanism and, for new facilities, it will mean they can revert to the long-standing market practice which existed prior to the contentious decision at first instance.

For fund managers, it means they can argue against requests for all-monies security from financiers, to the extent the request is based on concerns flowing from the first instance Octaviar decision. This is obviously an important issue for fund managers who have multiple financiers lending to one fund with security over separate assets of the fund.

For more information, please contact Brendan Ivers.



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Proposals for major overhaul of financial requirements for REs

On 30 September 2010, ASIC released Consultation Paper 140, which sets out ASIC's proposed amendments to the financial requirements obligations for responsible entities (REs). A copy of the consultation paper can be found at:

http://www.mcmahonclarke.com/ckfinder/userfiles/files/ASIC_Consultation_Paper_140.pdf.

Proposed reforms

ASIC flagged many of its proposed reforms in its submission to the Ripoll Inquiry. **The proposed reforms are wide ranging and may have a significant impact on the viability of small or struggling fund managers.**

In brief, the proposals are as follows:

1. Placing significant restrictions on an RE's ability to provide guarantees and indemnities (both in its corporate capacity and in its capacity as RE of a scheme).
2. Requiring REs to prepare, and make available to ASIC on request, rolling 12 month cash flow forecasts of anticipated revenue and expenses, approved by the RE's directors.
3. Increasing the net tangible asset (NTA) capital requirements for REs.

4. Specifying a minimum NTA liquidity requirement for REs, with 50 percent of the required NTA being in cash or cash equivalents and the remaining 50 percent of the required NTA being in "liquid assets".

Submissions

The outcome of this consultation will be of critical importance to the business models of all fund managers. **Submissions in response to the proposals are due by 15 November 2010.**

Once the proposals have been finalised, ASIC's proposed implementation period is as follows:

1. The reforms will be effective for new REs as of 1 July 2011.
2. A transition period for existing REs will be implemented at either—
 - (a) 12 months until 1 July 2012, or
 - (b) 24 months until 1 July 2013.

McMahon Clarke Legal will be making a submission in response to the proposals and we encourage you to contact us and provide us with feedback on the proposals which can be included in the submission.

Contact

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ASIC guidance on the content of PDSs

Updated regulatory guide

ASIC has recently re-released regulatory guide 168 *Disclosure: Product Disclosure Statements (and other disclosure obligations)* which updates and consolidates its policy on product disclosure statements (PDS).

RG 168 contains updated disclosure guidance for PDSs based on ASIC's key findings in a recent study of disclosure for capital protected products and retail structured or derivative products (ASIC Report 201). The study involved the review of 64 PDSs. Based on this review, ASIC highlighted the following concerns about compliance with disclosure obligations:

1. ASIC believes that a greater emphasis needs to be placed on effective presentation of information for complex products. This includes using user-friendly tools, diagrams and realistic examples, and limiting use of defined terms.
2. Important information about a product should not be omitted from the PDS. For example, in some PDSs ASIC reviewed, there was inadequate disclosure about 'feeder' funds, or funds which invest in another fund. ASIC found the PDSs were seriously deficient in disclosing the investment strategies of the underlying funds and they were particularly concerned where those underlying funds were located in a tax haven jurisdiction.
3. Comparisons of product returns to a benchmark such as an index should be approached cautiously; returns need to be comparable to the product.
4. ASIC also believes that better disclosure is required for break costs which may apply when an investor seeks to terminate or redeem a product before its maturity date.

Risk disclosure

ASIC were particularly focused on risk disclosure, and noted the following:

1. ASIC found the disclosure of risks in many PDSs was deficient and in some cases, it was structured in such a way that key risks were concealed. ASIC considers information about risks is important information which should be highlighted.
2. Appropriate prominence must be given to both the risks and benefits of a product, otherwise the PDS could be misleading because of the way the information is presented.
3. Investors should be provided sufficient disclosure about the risk of early termination or other limitations of capital protected products.
4. Counterparty risk associated with structured or derivatives products must be clearly and prominently explained. ASIC expects adequate supporting financial information to be provided (in the PDS or free of charge from the issuer) to ensure retail investors can assess the issuer's financial ability to meet its counterparty obligations.

Property funds

Whilst ASIC Report 201 documented ASIC's finding following the review of capital protected and structured product PDSs, a lot of the guidance is equally applicable to property fund PDSs.

ASIC will continue to conduct selective compliance reviews of PDSs to determine whether they comply with the PDS requirements. Additionally, ASIC may review PDSs as part of a targeted project, in response to a complaint, or at random. ASIC will, as before, notify issuers of disclosure concerns or issue a stop order if delay could be prejudicial to the public interest.



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Statutory novation of scheme property

Scheme property

The recent Federal Court decision in *Huntley Management Limited v Timbercorp Securities Limited* considers the breadth of the term "scheme property" and what is transferred to an incoming responsible entity under the statutory novation provisions of the *Corporations Act 2001* (Act).

Timbercorp

Timbercorp Securities Limited (Timbercorp) was the responsible entity of a number of registered agricultural schemes. It entered into three separate agreements with growers (i.e., investors in the scheme) who were to perform the work of producing crops for sale and commercial exploitation. The three agreements were—

1. a licence agreement for a portion of land on which the crops would be grown
2. a management agreement for the cultivation of the crops for sale, and
3. a marketing deed for the marketing of the crops.

The agreements stated that Timbercorp entered into the agreements "in its personal capacity".

Removal of RE

On 25 June 2009, the members of each of the schemes to which the case relates passed an extraordinary resolution to remove Timbercorp as the responsible entity (RE) and then appoint Huntley Management Limited (Huntley) as the new RE.

Upon replacement of Timbercorp as RE of the schemes, the statutory novation sections of the Act applied and the property of the schemes was

novated to Huntley as the new RE. However, Timbercorp argued that the agreements entered into with the growers were not scheme property and were not novated pursuant to the Act and that if Huntley wished to take the agreements, it would have to pay additional consideration.

Decision

The question considered by the Federal Court was what rights, obligations and liabilities of Timbercorp, as the former RE, became rights, obligations and liabilities of Huntley, as the new RE.

Given the disclosures in the schemes' constitutions, compliance plans and product disclosure statements, the Federal Court found that, despite the contracts explicitly stating that Timbercorp entered the contracts in its personal capacity, the rights, obligations and liabilities they created were in relation to the scheme and therefore subject to the statutory novation provisions.



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McMahon Clarke Legal banking and finance services

In the highly regulated funds management arena, it is important to have banking and finance lawyers that understand the general commercial risks for lenders and borrowers in a financing transaction, but they must also possess the specialist expertise required to understand the complexities involved in lending to, or borrowing on behalf of, a managed fund.

At McMahon Clarke Legal, we have a team of specialists with experience in dealing with complex financial transactions involving managed funds.

We have acted on both sides of transactions, for lenders and borrowers, in large and small scale financing transactions.

For borrowers, we are able to provide you with specialist advice to ensure you can negotiate your way through the commercial risks involved in raising debt on behalf of a managed fund.

For lenders, we can ensure your documentation clearly and adequately deals with the particular issues faced by a lender when seeking to enforce or recover against the trustee of a managed fund.

Our focus

At McMahon Clarke Legal, we focus on—

- speed of delivery
- key risk issues, taking into account our client's specific commercial drivers, and
- quality of service.

To discuss our services in more detail, please contact Brendan Ivers.



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Investor access to trust documents

Trustees' duties

Investors generally have high expectations about the way in which a responsible entity or trustee will manage a trust and the assets owned by it. From time to time, they may request access to information and documents in relation to the trust or the assets in order to satisfy themselves that the responsible entity or trustee is doing its job properly.

The law provides that a trustee (or responsible entity) has a duty to keep investors reasonably informed and to account to the investors in a trust. As a consequence of that duty, the trustee is obliged to keep proper accounts and, upon demand, allow inspection of "trust documents" by investors, or an agent appointed for that purpose (such as an accountant or lawyer).

What are trust documents?

Investors only have a right to inspect "trust documents", which are those documents which have the following characteristics:

1. They are in the possession of the trustee in its capacity as trustee.
2. They contain information about the trust which the investors are entitled to know.
3. The investors have a proprietary interest in the documents and are therefore entitled to see them.

The investors' right to inspect trust documents is not unfettered. There are a number of limitations on what investors may demand to inspect.

Privilege

The Court of Appeal in Western Australia recently had occasion to determine whether legal advice obtained by a trustee in relation to the administration of a trust was privileged and therefore need not be disclosed to an investor. In that case, the Court held that a trustee was not entitled to claim legal professional privilege over legal advice because the legal advice was given in connection with the management or administration of the trust, and the trustee and the investor therefore had a joint interest in the subject matter of the legal advice.

The court stated however, that joint privilege would not attach to the legal advice if the legal advice related to the personal rights or liabilities of the trustee in connection with an alleged breach of trust or threatened proceedings against the trustee.

Other exceptions

It is generally recognised that the following classes of documents are not trust documents and are therefore not required to be made available to investors for inspection:

1. Documents evidencing the reasons that a trustee has made his or her decision or exercised a discretion where the trustee is acting in good faith in the making of his or her decisions.
2. Documents between the trustee and a third party where there is a duty of confidence owed to the third party by the trustee.
3. Agendas and minutes of the meetings of the trustee.
4. Communications or documents passing between the trustee and a single investor.
5. Where disclosure is not in the interest of the investors as a whole.

In addition to the above exceptions, the investors' right to inspect trust documents may be influenced by the terms of the trust deed or constitution, which might limit the documents the trustee is required to make available for inspection or the class of persons the trustee is required to account to.

Conclusion

It is important that all trustees (including responsible entities) are aware of their duty to account and allow for inspection of trust documents to investors. If a trustee wishes to limit the amount or class of documents investors may inspect, then it is recommended that those limitations be included in the trust deed or constitution.



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Promotion to partner—Sarah Davies

On 1 July 2010, Sarah rejoined the McMahon Clarke Legal partnership, having previously been a partner from 2002 to 2005. Sarah has been with the firm since 2001.

Sarah has over 20 years' experience as a commercial litigator. She manages the firm's litigation and risk management practice. In this role, Sarah works closely with clients and their business advisers on any transactions where litigation expertise is required.

Sarah's areas of expertise include the following:

- Advising directors about their duties and responsibilities, particularly in the face of an attack on the company's business, or when restructuring or merger issues arise.
- Advising trustee clients about trust governance issues, and applying to the courts for orders in relation to trusts and managed investment schemes.
- Conducting shareholder oppression actions and derivative actions.
- Advising clients about corporate insolvency issues.
- Representing clients at contested hearings before regulators and in the court.
- Representing companies and their directors in class actions brought by disgruntled investors.
- Acting for parties in partnership, shareholder and joint venture disputes.
- Property-related litigation involving leases, development agreements and mortgages.
- Land resumption cases.
- Trade practices disputes.
- Negligence actions, including negligence claims against directors, advisors and professionals.



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