

# In the money

Capital Markets and Funds Management news

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## Introduction

The Australian capital markets have been alive and well in the second half of 2004. Notwithstanding the federal election, strong economic conditions have resulted in a broad range of capital market initiatives. The range of financial products available for investors has continued to broaden, with Westpac entering the funds market with its Bluewater prospectus; Macquarie and Deutsche Bank issuing further series of their listed CDOs; Tishman Speyer and Galileo Shopping America Trust offering interests in more US properties; and Macquarie Bank, through its listed trusts, offering opportunities in the energy sector through DUET, airports through MAp and roadways through Connect East. The IPO market has also continued strongly with listings of Babcock & Brown and biotech entrants Proteome Systems Limited and Sunshine Heart, among a range of other offerings. Capital management has also been a feature of the last half of the calendar year with Lend Lease, BHP Billiton and St.George entering the market in different ways for capital management purposes.

In this edition of *In the money*, we focus on how BHP Billiton and St.George have been managing their capital and also discuss a new tax ruling that has relevance for Australian borrowers.

As this will be our last edition for the year, we wish you all the best over the holiday season and a happy New Year.

# BHP Billiton: Australia's biggest buy-back

**In brief:** The drive for an efficient capital structure has seen a number of high-profile Australian companies conduct off-market share buy-back tenders in the past year. We advised BHP Billiton on its recent buy-back, the largest off-market buy-back in Australian history. Lead partner on the transaction, David Wenger, and Lawyer Tim Turton discuss some of the unique features of this buy-back.

A number of high-profile Australian companies that have conducted off-market share buy-backs in the past year include the Commonwealth Bank (February 2004), Westpac (May 2004) and Telstra (September 2004). While the Australian market is familiar with off-market share buy-backs, the buy-back recently conducted by BHP Billiton Limited is pioneering certain aspects of the process that will be of interest to those companies looking to implement a similar scheme.

## Background

An off-market buy-back tender is becoming a commonly used capital management mechanism in Australia. It allows a company to buy back its shares at a price that is less than the prevailing market price on the stock exchange because, among other things, the buy-back proceeds are treated in a manner that has Australian tax outcomes which may be valued by Australian resident shareholders.

AAR recently acted for BHP Billiton, which, on 23 November 2004, announced Australia's largest ever off-market share buy-back of 180.72 million shares at a total cost of approximately \$2.272 billion. The BHP Billiton buy-back was structured as if it were an equal access scheme, allowing eligible shareholders to tender any number of their shares at discounts of between five per cent and 14 per cent of the prevailing market price, or at a final price tender. The actual buy-back price that was selected by BHP Billiton represented a 12 per cent discount to the five-day volume weighted average price (**VWAP**) of BHP Billiton's shares prior to the close of the offer period.

## Key characteristics of the buy-back

Although similar, in many respects, to previous off-market share buy-backs, the following key characteristics of the BHP Billiton buy-back are relevant to companies with significant foreign

shareholders and those looking for greater certainty in their buy-back pricing structure.

### *Excluded shareholders*

Because of the number and diversity of BHP Billiton's shareholders, the buy-back faced the difficulty of excluding certain countries' shareholders whose laws did not allow them to participate on the terms proposed by the company. This was particularly the case in North America. BHP Billiton was able to obtain relief from the Australian Securities & Investments Commission (**ASIC**) to permit the buy-back to proceed as if it were an equal access buy-back, even though those shareholders were excluded from participating, on the condition that any shares were bought back at a discount of at least five per cent to the five-day VWAP of BHP Billiton shares at the close of the offer period.

The combination of the minimum five per cent discount, the unique Australian tax treatment for Australian resident shareholders (with part of the sale proceeds being regarded as a fully franked dividend and the balance being treated as proceeds on disposal) and the fact that non-Australian shareholders could obtain a more attractive outcome by selling their shares on market was sufficient for BHP Billiton to conclude that the relevant non-Australian shareholders would not be disadvantaged by being excluded from the buy-back. That conclusion was important in BHP Billiton's decision to proceed with the transaction, as well as ensuring that the deal did not create any regulatory issues.

### *Discount to market price*

In structuring its off-market buy-back, BHP Billiton introduced a new tender pricing structure. While the company continued to use the reverse Dutch auction approach of seeking offers from shareholders and then using those offers in a bookbuild process in order to set the buy-back price, BHP Billiton did not adopt the commonly used structure of giving shareholders a number of specified prices to choose from. Instead, BHP Billiton requested shareholders to bid a discount of 5-14 per cent to the five-day VWAP immediately before the close of the offer period. This was preferable for the company as, among other things, it:

- ensured that the pricing points remained relevant throughout the tender period, regardless of movement in BHP Billiton's share price;
- reduced the potential price range that was required under a fixed price structure; and
- provided increased certainty to participating shareholders by fixing the buy-back price by reference to the share price of BHP Billiton at the end of the offer period.

The interesting question will now be whether the market follows BHP Billiton's lead in using the fixed discount structure or reverts to the fixed price

structure, or whether both structures will be used depending on the circumstances of the company that wishes to engage in management of its capital.

#### *Minimum price condition and extended offer period*

In order to ensure that the fixed discount tender structure adopted by BHP Billiton could not result in shareholders selling their shares at a price that was lower than a price that they wished to receive, the company also gave shareholders the option of choosing a minimum price condition. The minimum price condition was another market first, and was a useful corollary to the fixed discount pricing structure.

Furthermore, BHP Billiton extended the tender period to midnight on the final day of the offer period so that shareholders could wait until the final five-day VWAP price was calculated before submitting their tender. Shareholders could then apply their preferred discount to the final market price and thereby obtain certainty as to what their buy-back price would be. The company committed to having the final five-day VWAP calculated before 6pm on the final day of the offer period and posted on its website, and to accept fax and CHES acceptances until the midnight deadline, in order to facilitate any shareholder concern in that regard.

## Conclusion

As more companies look to explore alternative means of returning capital to their shareholders, the flexibility and benefits associated with an off-market buy-back are making it an attractive option for consideration. BHP Billiton has demonstrated how companies may build on market practice in order to suit the company's particular circumstances and to achieve results that are better aligned with the company's capital management objectives.



*David Wenger*  
Partner

# St.George SAINTS

**In brief:** Partner Alex Ding and Senior Associate Victoria Poole examine the issues St.George needed to address as a result of the unique features of its recent share offering.

St.George Bank Limited (*St.George*) has recently completed the offer of a new class of preference shares called Subordinated Adjustable Income Non-refundable Tier 1 Securities (*SAINTS*). St.George raised \$350 million through the offer, which was considerably oversubscribed. In developing the *SAINTS*, it was necessary to take account of the proposed International Financial Reporting Standards (*IFRS*) and other issued capital of St.George.

## What are SAINTS?

*SAINTS* are redeemable, convertible preference shares that entitle holders to a non-cumulative dividend in preference to any dividends on ordinary shares.

*SAINTS* have no necessary maturity. Holders do not have a right to require St.George to redeem, buy-back or cancel the *SAINTS* or convert *SAINTS* into ordinary shares – these events may only occur in certain circumstances at the sole option of St.George or on 20 November 2014.

The dividend rate is a floating rate calculated as 1.35 per cent per annum above the prevailing 90-day bank bill swap rate, reduced by the Australian corporate tax rate of 30 per cent.

If St.George does not redeem, buy-back, cancel or convert *SAINTS* by 20 November 2014, the margin of 1.35 per cent will be increased by a one-time step-up of one per cent per annum. The *SAINTS* are the first 10-year<sup>1</sup> hybrid offered to retail investors in Australia.

*SAINTS* are quoted on the Australian Stock Exchange.

## Not a reset preference security

The *SAINTS* are not reset preference shares. The reset feature of hybrid securities issued in recent times is no longer viable if the security is to be classified as equity. This is particularly important to companies in the financial sector that need to maintain certain levels of APRA-designated Tier 1 capital.

<sup>1</sup> APRA Guidance Note 111.1 requires that for an instrument to qualify as Tier 1 capital, any step-up provisions (such as a step-up in the margin) cannot operate for the first 10 years of the instrument's life, and there can only be one step-up during the instrument's life.

Under the terms of the traditional reset hybrid, the holder or the issuer will have the right to redeem or convert the hybrid into ordinary securities upon the reset date, or upon the happening of certain trigger events.

St.George received accounting advice that the SAINTS should be classified as equity under both Australian Generally Accepted Accounting Principles and IFRS. This is because St.George has no obligation to deliver cash or another financial instrument to the holder – St.George has the right to never repay the SAINTS capital to holders, and dividends are purely discretionary.

Under the IFRS, proposed IAS32 will operate to classify an instrument as equity if there are no contractual obligations on the issuer in certain specified circumstances. For example:

- an instrument may be classified as equity if it is a non-derivative that may be settled in the issuer's own equity instruments but includes *no contractual obligation* for the issuer to deliver a variable number of its own equity. In the case of the SAINTS, St.George has the right, but not the obligation, to redeem for cash or a variable number of shares;
- if there is an event that is outside the control of either the issuer or the holder of an instrument, which upon occurrence, will *require redemption* of the instrument, the instrument should be classified as a liability. In the case of the SAINTS, St.George has the right to redeem/convert upon occurrence of a trigger event, but is not obliged to do so;
- in relation to the dividend rate step after the 10<sup>th</sup> anniversary of issue, St.George has the ability not to pay dividends as they are purely discretionary. Once again, the dividend rate step-up does not impact on the equity classification of SAINTS, as there is no obligation to pay dividends or redeem the SAINTS on the step-up date.

Because under the terms of the traditional reset hybrid security, the holder or the issuer will have the right to redeem or convert the hybrid into ordinary securities upon the reset date or upon the happening of certain trigger events, this results in the issuer being *obliged* to redeem/convert the hybrid. Under the new accounting standards, such hybrids would no longer be classified as equity.

The equity classification is important where the issuer wishes to have the financial instrument treated as Tier 1 Capital. In its release dated 5 April 2004, the Australian Prudential Regulation Authority (**APRA**) indicated that instruments approved as Tier 1 prior to 31 March 2004 will be grandfathered or subject to transitional arrangements. APRA has stated that instruments approved after 31 March 2004, and which come to be accounted for as debt under IFRS,

may cease to be eligible for Tier 1 Capital post-IFRS. There is no current intention by APRA to grandfather new issues.

In connection with the SAINTS offer, APRA approved the issue to be included as part of St.George's Tier 1 Capital. However, APRA stated that it was unable to confirm classification of the SAINTS as equity under IFRS. This is because there is a possibility that the final IFRS may differ from the currently envisaged regime.

## Buy-back agreement

In addition to its rights of redemption, cancellation and conversion, St.George may buy back SAINTS on 20 November 2014 or on any subsequent dividend payment date, or upon the occurrence of a tax or regulatory event, as defined in the terms of issue (the *terms*).

One unique feature of the SAINTS is the buy-back agreement, annexed to the terms. The buy-back agreement is designed as a mechanism for putting in place the terms of any buy-back of SAINTS that might occur if certain conditions are met and before the decision to buy back has been made. This has many advantages, including certainty of terms on which any unwind of the instrument may take place, and greater choice is available to St.George in terms of means to unwind the instrument. Great care needs to be taken with this feature of the SAINTS, otherwise the risk of unlawful self-acquisition may result and inadvertent suspension of rights on shares might occur.

## Dividend stoppers

SAINTS rank equally with the St.George Preferred Resetting Yield Marketing Equity Securities (**PRYMES**) in respect of payment of dividends and equally with holders of PRYMES and Depositary Capital Securities (**DCS**) for any return of capital or payment of declared but unpaid dividends on a winding up.

The terms contain a dividend stopper that operates to prevent payment of dividends on lower ranking shares (ie ordinary shares) until an amount equivalent to one year's worth of unpaid dividends has been paid on the SAINTS.

The scope of the SAINTS' dividend stopper was considered in light of the other class of equal ranking preference shares issued by St.George, the PRYMES. In addition, the DCS (despite not being issued directly by St.George) were also relevant because the payment of dividends on those securities is guaranteed by St.George.

Therefore, unlike other recent hybrid securities, the SAINTS have three dividend stoppers. The operation of the three dividend stoppers is complementary in that none of them ever operates to freeze the payment of dividends as between SAINTS, PRYMES and DCS

– this is because of the effect of the pro rata carve-outs that are contained in the dividend stoppers. There is one exception: if the SAINTS remedial payment of six months worth of dividends is not paid on SAINTS and PRYMES, no dividends are payable on SAINTS, PRYMES or ordinary shares (but payments of dividends on DCS are unaffected).

The above discussion highlights the importance of taking account of the effect of dividend stoppers where a company wishes to issue different classes of preference shares in the future, and the effect of current dividend stoppers on any new class of preference share. It is important to ensure that the dividend stoppers operate as they are intended, ie to effect a preference to the holders of the relevant class of shares but without adversely impacting on the preference of one class of preference shares *vis a vis* another.

## Conclusion

The issue of SAINTS shows the importance of the IFRS on the structure of new hybrid securities. In addition, it highlights the need for issuers to take account of existing capital in structuring new equity and to be mindful that in issuing new equity, the terms of issue do not act as a fetter on future issues of new instruments. In respect of the SAINTS, the buy-back agreement feature was included to provide some flexibility in this regard.



Alex Ding  
Partner

# Tax treaty relief from Australian interest withholding tax for US or UK financial institutions

**In brief:** Partner Diccon Loxton and Senior Associate Thomas McAuliffe highlight certain aspects of a new draft Taxation Ruling on withholding tax and discuss the practical implications for Australian borrowers.

Since Australia entered into revised double tax treaties with the United States and the United Kingdom during the past two years, both lenders resident in those countries and Australian borrowers have been tentatively considering the new 'Interest' Article in each of those treaties. That Article exempts payments of interest to some US and UK lenders from Australian interest withholding tax (*IWHT*). Some welcome guidance on this issue has been released by the Australian Taxation Office (*ATO*) in the form of a draft Taxation Ruling (TR 2004/D16).

## The new 'Interest' Article

Under Article 11 of each of the double tax treaties between Australia and the US and the UK, Australia may not tax interest arising in Australia that is beneficially owned by a resident of the US or the UK if that interest is derived by a 'financial institution' that is unrelated to and dealing wholly independently with the payer. For the purposes of each treaty, 'financial institution' is defined to mean:

a bank or other enterprise substantially deriving its profits by raising debt finance in the financial markets or by taking deposits at interest and using those funds in carrying on a business of providing finance.

In the draft ruling, the ATO states that it will interpret this definition as comprising two distinct categories of financial institution, being:

- banks; and
- other enterprises substantially deriving their profits from raising debt finance in the financial markets or by taking deposits at interest and using those funds in carrying on a business of providing finance.

## Which entities will be accepted as 'banks'?

According to the draft ruling, the ATO will regard as banks entities that are residents of the US or the UK that:

- have been granted their principal licence to operate as a bank in either the US or the UK where they are resident respectively, *as distinct from operating in either country as the holder of a foreign banking licence*; and
- satisfy the capital adequacy requirements necessary to operate as a bank, as distinct from other categories of deposit-taking institutions, in either the US or the UK.

Where an entity satisfies these requirements, the ATO will accept that it is a 'bank' for the purposes of each treaty, in which case it will not need to satisfy the other elements of the 'financial institution' definition. Subsidiaries of banks, that do not themselves hold a banking licence, will not be regarded by the ATO as banks and will therefore need to satisfy the 'other enterprises' category of financial institution (see below).

Credit unions, building societies and saving and loans institutions that have lower capital adequacy requirements than those required of banks will not be regarded as banks by the ATO. However, those entities may still qualify as financial institutions for the purposes of the treaty where they satisfy the additional requirements applicable to 'other enterprises'.

## Other enterprises substantially deriving their profits from spread activities

Where an enterprise does not meet the ATO's criteria for a bank, it may nevertheless qualify as a financial institution for the purposes of the treaties if it substantially derives its profits by raising debt finance in the financial markets, or by taking deposits at interest, and using those funds in carrying on a business of providing finance.

This definition of financial institution comprises numerous elements, each of which is considered in some detail by the draft ruling. The manner in which the ATO has dissected the definition of this category of financial institution, and the examples given in the draft ruling, amplify the need to undertake a careful and detailed analysis of whether protection from IWHT will, in fact, be available under the new 'Interest' Article in each of the treaties.

## Exceptions to the zero withholding rate for 'financial institutions'

The draft ruling also discusses the circumstances in which Australia will retain the right to tax interest arising in Australia because:

- the US or UK financial institution is related to, and not dealing wholly independently with, the Australian borrower;
- the interest is effectively connected with an Australian permanent establishment of the US or UK financial institution; or
- the interest is paid as part of an arrangement involving 'back to back' loans.

## Risk allocation issues

It will be important for Australian borrowers to appreciate that they bear the primary risk associated with the non-payment of IWHT if it transpires that the US or UK lender is not, in fact, entitled to the zero withholding rate under the relevant treaty, *even where there is no gross-up clause*.

If an Australian borrower failed to withhold an amount of IWHT payable for interest paid to a US or UK lender, the Australian borrower would be liable for the amount of tax that should have been withheld and remitted to the ATO, together with any late payment interest and, possibly, penalties. Any income tax deductions that the Australian borrower had claimed for the relevant interest expense would also be jeopardised.

Therefore, the losses that an Australian borrower may sustain could be significant. In this regard, it is worth noting that many of the factors on which eligibility for treaty protection rests are matters that will be primarily, if not solely, within the knowledge and control of the lender. Accordingly, Australian borrowers from US or UK lenders who claim to be entitled to the zero withholding rate under the US or UK treaty should require:

- a warranty from the lender that it is entitled to the zero withholding rate under the relevant treaty, together with a representation that it will continue to be so entitled (subject to a change in law);
- an undertaking by the lender to notify the Australian borrower on a timely basis if it ceases to be entitled to the zero withholding rate; and
- an indemnity from the lender for any amounts payable by the Australian borrower to the ATO if that warranty or representation turns out to be incorrect, or if it breaches the undertaking.

Of course, where an Australian borrower undertakes a borrowing by way of an issue of debentures that satisfies the 'public offer test' and other requirements

of the section 128F exemption from IWHT, it will not be necessary for the parties to consider whether the US or UK lender is entitled to the zero withholding rate under the relevant treaty. That remains a safer option when available.



*Diccon Loxton*  
Partner

## Small change

### ATO audit activity – GST and IPOs

In a recent Financial Services Industry Partnership meeting, the Australian Taxation Office (**ATO**) confirmed that it is undertaking a project to audit goods and services tax (**GST**) input tax credits claimed in the context of initial public offerings. This follows on from the ATO's statement in its Compliance Program for 2004-05 that 'we are paying close attention to companies that incorrectly claim full input tax credits for acquisitions on share sales and purchases'. The possibility of a public ruling on these issues has been flagged.

We are now seeing significantly increased audit activity in relation to initial public offerings (**IPOs**) and merger and acquisition transactions. Input tax credits for costs incurred in these areas are under close scrutiny with audits often triggered by claims for GST refunds. The application of the reduced input tax credit regime is the target of particular attention. Disagreements as to its application are likely to be frequent given the very general wording of the relevant regulations.

In situations where a single entity acquires services in relation to issuing, buying or selling shares there is little that can be done to determine the GST position. However, where more than one entity in a group is involved, it is important to ensure that acquisitions are made, and paid for, by the entity with the greatest entitlement to input tax credits.

### Dollar disclosure regulations

On 7 October, the Australian Securities & Investment Commission (**ASIC**) issued class order relief 04/1176 to extend the date for compliance with the dollar disclosure regime from 1 January 2005 to 1 March 2005. ASIC announced that the class order relief provides Australian financial services licensees (and their representatives) and product issuers with a further two month extension to the transitional period, meaning that they will now need to disclose various fees and benefits (as required under the regulations) as amounts in dollars in statements of advice, product disclosure statements and periodic statements prepared on or after 1 March 2005. However, as previously indicated, ASIC is encouraging those in a position to comply with the requirements before the end of the transitional period to do so.

ASIC had foreshadowed the possibility of extending the transitional period when it released its policy proposal paper on 10 August. (see ASIC's website at [www.asic.gov.au](http://www.asic.gov.au)) The paper outlines how ASIC plans to approach the dollar disclosure provisions and how it proposes to use its power under the new regulations to make dollar disclosure determinations.

ASIC announced that it expects to issue a final policy statement on dollar disclosure in November 2004.

For further details about the class order, refer to ASIC's website at [www.asic.gov.au](http://www.asic.gov.au).

## Changes to remuneration disclosures by registered schemes

ASIC has announced short term relief for disclosing entities in relation to disclosing details of remuneration paid directly or indirectly to directors and executives of their responsible entities.

Class Order 04/0967 provides short term relief from any requirement for financial reports of registered schemes that are disclosing entities to reveal remuneration paid directly or indirectly to directors and executives of their responsible entities. The class order covers financial years and half-years ending 30 June 2004 up to, but not including, 30 September 2004.

The class order was made following a request by the Australian Accounting Standards Board. Further information is contained in the ASIC media release, available at [www.asic.gov.au](http://www.asic.gov.au).

## Transaction costs in registered managed investment scheme constitutions (section 601GA) – ASIC's interim position

On 9 July 2004, ASIC announced that, until 31 December 2004, it will consider granting case-by-case relief to remove the need for scheme constitutions to contain a mechanism that is 'certain, complete and independently verifiable' for calculating the transaction costs component of the price of an interest in the scheme (ie the amount added to the issue price or deducted from the proceeds when a member withdraws from the scheme). Until the end of the year, ASIC will take no action in relation to constitutions of existing schemes that do not contain such a mechanism.

Before this announcement, ASIC had adopted a practice of rejecting constitutions that included what industry considered to be a fairly standard definition of 'transaction costs'. However, as a result of industry feedback, ASIC recognised that its position had the potential to cause practical difficulties for fund managers and, therefore, ASIC decided to adopt this interim position while it continues its dialogue with industry. ASIC has issued a consultation paper on 1 October, *Proposed relief for constitutions of registered managed investment schemes*. Comments on the consultation paper were due by 30 November 2004.

For new schemes, it will be a condition of the relief that the basis for calculating the transaction costs be disclosed in the scheme's product disclosure statement.

Further information on the relief can be obtained from ASIC's website at [www.asic.gov.au](http://www.asic.gov.au).

## ASIC concern in relation to high yield investments

ASIC has issued a further warning to consumers about high yield investments including debentures and unsecured notes.

In a statement released in late July (see ASIC's website at [www.asic.gov.au](http://www.asic.gov.au)), ASIC's director of corporate finance, Richard Cockburn, noted that in 2003-04, ASIC had issued stop orders in respect of more than \$1.8 billion in debenture fundraising until offending prospectuses were corrected. Examples included:

- failing to update information about a major loan being in arrears, giving the impression that it was about two months behind when it was actually six years behind;
- failing to advise that a company had breached its annual lending limit; and
- potentially misleading information suggesting that investors had security over real estate.

This has been an issue of continuing concern to ASIC, which has released a number of warning statements in relation to high yield investments:

- ASIC focuses on defective debenture prospectuses (see ASIC's website at [www.asic.gov.au](http://www.asic.gov.au)); and
- putting the stop to defective prospectuses (see ASIC's website at [www.asic.gov.au](http://www.asic.gov.au)).

In the 2002-03 financial year, ASIC placed a total of 89 stop orders on defective prospectuses seeking to raise more than \$383 million from the public.

We understand that ASIC has been vigilant in approaching financial institutions who it believes are in breach of the *Corporations Act* requirement to describe certain debentures as 'unsecured notes' rather than 'debentures'. Many of these institutions have been issuing such paper as 'debentures' for years.

## Our Capital Markets and FM-RES Groups

Our capital markets practice group draws on the expertise and resources of more than 100 lawyers in Australia and the South-East Asian region. The group is led by Jon North, backed by deputy leader Craig Henderson. The group operates as a cohesive team covering the corporate and finance law and tax aspects of the issuance of debt, equity and hybrid securities.

As well as securities issuance, we cover the entire capital markets field, including capital management, trading systems, trading behaviour regulation and corporate governance.

We have worked on Australia's most significant capital raisings including initial public offerings, institutional offers and rights issues. Our expert knowledge of the capital markets helps us create novel solutions, whether through new financial instruments or creative use of existing products.

Our capital markets group works closely with our Funds Management Real Estate and Superannuation practice group. The FM-RES practice group is a full-service corporate real estate and superannuation team. The groups services all aspects of asset management and has particular skill in complex structured transactions (including developments) and funds management products which involve real estate. We have some of Australia's leading experts on managed investments law and real estate law. The teams advise some of Australia's largest fund managers, corporations and multinationals, including having acted on some of Australia's most significant real estate deals, trust floats, mergers and development projects and having devised sale and leaseback transactions for major banks and corporations.

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