

Financial Services Quarterly

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Bell Gully





Welcome to the Autumn 2006 issue of *Financial Services Quarterly*, a review of current legal issues in the financial sector.

Each quarter, we summarise recent issues and preview upcoming developments under these headings:

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In the courts

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A comparison of the American and Australian approaches to the enforceability of letters of comfort.

Age discrimination and bank lending

This article considers implications of the prohibition on age discrimination contained in the Human Rights Act 1993 for bank lending.

Smart card technology rejected

Smart card technology rejected because "there is nothing wrong with cash".

Legislation/In Parliament

Securities Legislation Bill – discussion document released

A discussion document on the Securities Legislation Bill was released by the Ministry of Economic Development in March.

Review of financial products and providers - update

A review of financial products and providers is currently being undertaken by the Ministry of Economic Development.

Significant changes planned for taxing offshore investments

The Government has released details of a revised set of rules for the taxation of investment income of New Zealand investors.

Financial intermediaries: Cabinet agrees to co-regulatory model

Cabinet has agreed to the adoption of a co-regulatory model for regulation of financial intermediaries, where industry-led “approved professional bodies” and the Securities Commission will work together to regulate financial intermediaries.

Financial Reporting Act review

Reform of the Financial Reporting Act is scheduled to take place in December.

Trans-Tasman taskforce takes up the fight against scams

The Australasian Consumer Fraud Taskforce has launched a trans-Tasman campaign to inform consumers about the most common types of scams and how to recognise whether an offer is genuine or false.

Ministers announce key achievements in the trans-Tasman single economic market agenda

A number of measures have been announced to accelerate moves to remove barriers between the New Zealand and Australian economies.

Review of the redress and enforcement provisions of consumer protection law

The Ministry of Consumer Affairs has published an international comparison discussion paper comparing our Fair Trading Act 1986 and Consumer Guarantees Act 1993 with the consumer protection legislation in Australia, Canada, the United States and the United Kingdom.

Recent developments

Securities Commission reviews financial reports

The Securities Commission is carrying out an ongoing financial reporting surveillance programme to review the reporting practices of issuers, with the aim of encouraging New Zealand issuers to improve the quality of their financial reporting.

Bank capital, risk management and the economy

In a speech given by the Deputy Governor and Head of Financial Stability of the Reserve Bank of New Zealand, Adrian Orr, the focus was on implementation of the new Basel II capital adequacy framework.

In the courts

Undue influence clarified in the context of family guarantors

The High Court has revisited the authorities on undue influence and held in this case that there was not sufficient evidence to grant summary judgment.

The case¹ involved an application for summary judgment brought by a creditor against a wife who personally guaranteed her husband's company's debts.

In late 2001, the creditor advanced funds to the company for the purchase of two truck and trailer units. A security interest was taken over the truck and trailer units and personal guarantees were given by five individuals (including the wife).

When, in 2004, the company defaulted on its obligations, the creditor terminated the agreement and sold the truck and trailer units. However, the proceeds were insufficient to repay the debt.

The husband subsequently passed away and the company went into liquidation.

The creditor served notice on the remaining guarantors who each admitted liability except the wife, who claimed that her guarantee was unenforceable because she was unduly influenced to enter the agreement by her late husband.

The High Court noted that, to avoid a guarantee by reason of undue influence, the following three elements must be proved:

1. *The guarantor was subject to undue influence*

The Court considered the decision in *Hogan v Commercial Factors Limited*.² In that case, the judge suggested that a wife who has provided a guarantee for her husband can only avoid liability by establishing that her husband actually exercised undue influence over her (as opposed to earlier authorities that suggested the relationship *itself* gave rise to a *presumption* of undue influence). The judge stated that this is now the position in New Zealand.

Bearing in mind that this was a summary judgment application, the judge was of the view that the wife was subject to undue influence. She had little understanding of commercial affairs, always allowed her husband to make the business decisions and trusted his judgement absolutely in that respect.

2. *The creditor had been "put on inquiry" as to the risk of undue influence.*

The Court had to determine whether the creditor had constructive knowledge of the undue influence. In doing so, the Court had to decide whether to apply the rule in the English case *Royal Bank of Scotland v Etridge (No. 2)*³, where a bank is put on inquiry in every case where a wife stands as surety for her husband's debts, or the more stringent test in *Wilkinson v ASB Bank Limited*⁴, where a creditor is put on inquiry where:

- the transaction on the face of it is not advantageous to the wife; and
- there is a substantial risk that the husband has committed a legal or equitable wrong.

¹ *Rabobank New Zealand Limited V Logan Donald Balderston & Anor* (Wellington High Court, 30 March 2006, Civ-2006-485-117)

² CA225/03, 10 November 2005

³ [2001] 4 All ER 449 (HL)

⁴ [1998] 1 NZLR 674

The Judge noted that the Court of Appeal in *Hogan* praised the *Etridge* approach. Nevertheless, bearing in mind the nature of the application, the Judge followed what he considered to be the existing law in New Zealand and applied the *Wilkinson* approach. Accordingly, he found that the creditor had been put on inquiry because the transaction was not advantageous to the wife.

3. *The creditor had failed to take "reasonable steps" to insulate itself from such undue influence.*

The guarantee document contained a clear explanation of the effect of the guarantee and a waiver of independent legal advice, which the wife had signed. However, this was not enough. Based on the principles in *Hogan* and *Wilkinson*, the Judge held that the creditor had a duty to *bring home* to the wife the risk she was running and it failed to do so.

The application for summary judgment was declined.

Supply on retention of title terms – can an overly broad financing statement be seriously misleading?

*The High Court has considered whether or not a supplier had a perfected purchase money security interest (a **PMSI**) in respect of goods supplied on retention of title terms.*

In this case¹, two financing statements were registered at the Personal Property Securities Register (**PPSR**):

- first, by a bank in respect of a general security agreement over all of the company's assets; and
- second, by the supplier in respect of the goods supplied on retention of title terms.

In determining which security interest had priority, the court had to consider whether the supplier's financing statement contained an adequate description of the collateral or whether the collateral type and description did not properly reflect the security interest and therefore did not perfect it. In other words, was the financing statement seriously misleading, rendering it invalid?

The court considered three questions:

1. *Does the supplier have a security interest in the goods supplied?*

The receivers claimed that the terms of trade agreement was void because it did not reflect the actual terms of trade as conducted. They argued that the payment for supply arrangement was a verbal agreement between the parties.

The terms of trade provided that:

- *"prior to the buyer paying in full for all goods supplied to the buyer by the company, ownership of any such goods will remain with the company".*
- *"If the buyer on-sells any goods (supplied by the company) before ownership has passed to the buyer, the proceeds of such sale shall be received and held by the buyer in trust for both the company and the buyer."*
- *"The buyer agrees that, for the purposes of the Personal Property Securities Act 1999 (the "PPSA"), the company has a security interest in the goods supplied by the company to the buyer (as detailed) in each invoice supplied to the buyer as well as the proceeds of such goods."*

The court determined that although the modification to the terms of trade relating to how payments were to be made should have been in writing, this did not render the entire terms of trade void. The terms of trade accurately recorded the contractual relationship between the parties.

The receivers also challenged the retention of title clause used in the terms of trade. They claimed the language was outdated and did not create a security interest.

The court determined that the inclusion of a retention of title clause is a material and permissible term of trade and is enforceable.

The court held that the terms of trade:

- satisfied the section 16 definition of "security agreement" – they amounted to an agreement that creates or provides for a security interest and included writing that evidenced a security agreement; and
- satisfied the section 17 definition of "security interest" – a "conditional sale agreement (including an agreement to sell subject to retention of title)" comes within the definition of a security interest. It is

¹ *Service Foods Manawatu Limited (In Receivership and Liquidation) v NZ Associated Refrigerated Food Distributors Limited* (High Court, Wellington, CIV-2005-485-1820, 30/01/2006)

the substance of the arrangement securing the payment or performance of an obligation that is contemplated by section 17 rather than the form of the arrangement.

The court concluded that the security interest was a PMSI.

2. *If there is a security interest, was it perfected by the registration of a financing statement?*

There was a financing statement registered at the PPSR. However, the following question was relevant to determine whether the security interest was *perfected* by registration.

3. *Is there a seriously misleading defect, irregularity, omission or error in the financing statement to render the financing statement invalid?*

The court focussed on the following sections of the PPSA:

- Section 41 – a security interest is perfected when it has attached and a financing statement has been registered.
- Section 142(1)(e) – a financing statement must include a description of the collateral.
- Section 149 – a financing statement is only invalid if it is seriously misleading.
- Section 150 – a financing statement is invalid if there is a seriously misleading error in the debtor's name or in a serial number.

The supplier's financing statement recorded the collateral type as "All Present And After Acquired Personal Property". The receivers claimed that this was seriously misleading because it was too broad and did not properly describe the goods supplied.

The court held that the financing statement perfected the security interest and was not seriously misleading. The collateral description may have been overly broad, but the supplier's valid security interest was confined to the goods and proceeds described in the terms of trade.

Covenantors can be sued as principal debtors

This case considered whether a mortgage signed by a covenantor binds that covenantor as principal debtor, and whether a material change in the underlying transaction can release a guarantor from liability.

In this case¹, a creditor advanced a loan to a company. The loan was signed by the company and by its sole director as guarantor, but the document did not contain any guarantee provisions. The loan was secured by a mortgage over a building. The director signed the mortgage as covenantor. The arrangement also included an agreement to grant a deed of assignment of leases (including rental income) associated with the building.

The loan was advanced and, a few months later, 15 titles were issued. Three of the titles were sold, and the creditor released its mortgage without requiring the company to repay any of the loan.

The company defaulted on an interest payment and subsequently defaulted in repayment of the principal amount. The creditor served notices to sell under the Property Law Act (the **PLA**) on the company and on the director.

The company went into liquidation and the remaining 12 titles were sold by mortgagee sale. The creditor then applied for summary judgment against the director for the shortfall of over \$1 million.

The court identified five main issues to consider:

1. *Did the creditor comply with the PLA?*

The court found that it did.

2. *Is the director liable as a guarantor or as a principal debtor?*

The court decided that the director was liable as a principal debtor and not solely as a guarantor for the following reasons:

- The definition of "Mortgagor" provided that:

"the covenants in the mortgage shall bind all persons jointly and severally and any Covenantor as a principal debtor".

There was some argument around the definition of "Mortgagor", but the court considered the context and determined that it wasn't unreasonable for the director to be binding himself as a principal debtor since he was the sole director and shareholder of the borrower.

- The fact that the director was sued by the creditor as a guarantor was irrelevant because the only basis on which he could be sued was under the mortgage.

3. *If the director is a guarantor only, has there been a material change that releases him from liability?*

Since the director was liable as a principal debtor, the question about whether there had been a material change that would release him from his obligations as a guarantor was irrelevant. However, the court did say that, if he had been a guarantor and not a principal debtor, then he would have had an arguable case for a material change occurring, since there was no reduction in the principal sum owing to the creditor when the company sold the three units subject to its mortgage.

4. *Did the creditor breach its duty of care as mortgagee when it sold the remaining 12 titles? Is there any other reason for declining summary judgment?*

The creditor did not breach its duty of care as a mortgagee when it sold the 12 units because the duty of care (as codified in section 103A of the PLA) provides that it is only owed to the mortgagor (and the

¹ *National Mortgagee Nominee Company v Clark (2006) 5 NZ ConvC 194, 242*

definition of mortgagor in the PLA is not wide enough to capture principal debtors). The director would only get the benefit of section 103A if he had made payments under the guarantee and acquired an interest or rights in the security.

5. *Negligence*

Despite answering each of these questions against the director, the court refused to award summary judgment in favour of the creditor. The court reasoned that the director may have a claim in negligence against the creditor for the manner in which the security was released. The three apartments sold by the company were the most profitable, were sold at a time when the company was in default under the mortgage, and the net proceeds from the sales were not applied in reduction of the principal sum.

If negligence was found, then this could give rise to set-off.

What constitutes commercial sense and not “financial assistance” by a company to facilitate the sale of its shares?

A recent English case provides an example of where a credit and security arrangement that discharges a purchaser's liabilities does not constitute financial assistance by the company for the purchase of its shares.

In the situation where a target company owes its parent company a substantial debt, a purchaser may buy the entire share capital of the company for a negligible price but undertake to guarantee the performance of the target company of its indebtedness to the parent company.

This case¹ supports the proposition that the purchaser will not be financially assisted if the target company then legitimately refinances with a third party to repay the indebtedness that was guaranteed by the purchaser.

Further, it may not be financial assistance if the target company provides security to its parent company for the guarantee given by the purchaser. This depends on the commercial reality of the transaction.

The case centres around section 151(2) of the UK Companies Act 1985 for which there is no equivalent provision in New Zealand. However, the case is still useful in so far as it provides an example of a transaction that would not be classified as financial assistance and therefore, not fall under the ambit of the approval procedures governing financial assistance in New Zealand.

¹ *Anglo Petroleum Ltd v. TFB (Mortgages) Ltd* [2006] EWHC 258 (CH)

Court approves Matauri-X loan repayment

The Maori Land Court has made an order allowing Matauri-X to refinance and repay its outstanding loan.

The Winter 2005 issue of *Financial Services Quarterly* covered this case, where Matauri X borrowed \$3 million to invest in a water supply business that subsequently failed.

The creditor had taken security over Matauri-X's land but the Court of Appeal found that the mortgage was unauthorised because the company's objects did not allow it to enter into loan and security arrangements for this type of business.

The creditor was granted leave to appeal to the Supreme Court on the basis that it was not required to enquire as to the necessity of the loan or its application.

Since that time, the case has been moved into the Maori Land Court, which has made orders allowing Matauri-X to refinance to repay the outstanding loan. Taking the Court of Appeal's decision into account, the Maori Land Court found that the mortgage was outside Matauri-X's powers and so its constitution had to be altered by the Maori Land Court to allow repayment.

In the journals

Voidable transactions: payments made by receivers when trading on

Greg Blanchard and Ben Russell, *The New Zealand Law Journal*, February 2006

This article discusses a decision of the Wellington High Court in the first New Zealand case dealing with the issue of who a receiver acts for when it makes payments of pre-appointed unsecured debts and when liquidation follows receivership.

The recap of this case follows a recent article¹ that disputes the High Court's decision. The authors of this article believe that the case was decided correctly.

In the case², a meat slaughtering and processing company had granted a debenture over all of its assets to a bank. Chartered accountants appointed by the bank revealed that the company was performing poorly financially and, after non-compliance with a demand, receivers were appointed.

The receivers decided that the company should continue to trade, but only by providing slaughtering and processing facilities to owners of stock, and no longer purchasing and on-selling livestock. The receivers made six payments to suppliers who had supplied livestock in the period before the receivers were appointed.

There were no retention of title provisions in the supply arrangements. However, the receivers decided that the stock, recently supplied to the company belonged to the suppliers and, in their mind, the company held the livestock on trust for those suppliers. Therefore, it was deemed inappropriate for the company to have taken the livestock on credit when payment could not have been made, so, rather than returning the stock, the receivers made payments to each of the suppliers.

Subsequently, liquidators were appointed to the company, who issued notices to each applicant seeking to set aside the payments under section 292 of the Companies Act 1993.

The applicants applied to set aside the notices on the grounds that:

- the payments were not "transactions" under the Companies Act as they were not "the payment of money by the company"; and
- if section 292 did apply, the payments were made in the ordinary course of business and so were not voidable.

The majority judgment held that the receivers made payments as agents of the secured creditor and refused to set them aside.

In addressing the first ground, the court determined that, when the receivers were appointed, the company lost its ability to dispose of its assets. Therefore, the receiver could not be acting as the agent of the company because the company did not have the power to authorise the receiver to do so.

With reference to the second ground, the court determined that the payments were outside the six month period, so the presumption under section 292(3) (that the payment was made otherwise than in the ordinary course of business) did not apply. The court considered whether the appointment of receivers and the change in business had effectively terminated the company's "ordinary course of business" as such and concluded that, as the payments made by the receiver would have been made despite the changed

¹ Brown, *Receivers and Voidable Transactions* (2005) 11 NZBLQ 95

² *Re Lakeview Farm Fresh Ltd (in rec and liq)* [2006] 1 NZLR 238

circumstances of the business, the payments were viewed as being in the company's ordinary course of business.

The authors' opinion is that the case was rightly decided from a practical point of view as it confirms that payments of pre-appointed debts by a receiver can be confidently accepted by unsecured debtors and cannot be claimed back by a liquidator. This has the benefits of:

- ensuring the company's continuity of supply;
- enabling the receiver to continue to trade (thereby maintaining or potentially increasing the value of the company's assets); and
- providing an alternative to an asset sale, which often results in a loss in value for all parties.

Retention of title and the trans-Tasman supply of goods

Juliet Taylor, *New Zealand Business Quarterly*, March 2006 v12

This article considers the effect of the different security regimes in New Zealand and Australia on supplies of goods on retention of title terms.

Sales on retention of title terms are a commercial law development allowing the seller/supplier of goods to employ "quasi-security" devices to secure repayment and allow them to take back goods that have not been paid for if the buyer becomes insolvent. Generally, the supplier will have priority over other creditors in respect of those goods.

The Australian High Court has directly applied the principles of *Romalpa*¹, the case that gave retention of title suppliers the rights described above.

In New Zealand, the enactment of the Personal Property Securities Act (**PPSA**) has resulted in an entirely distinct regime in respect of retention of title clauses.

The author of this article identifies a number of implications arising from this divergence in regimes.

Australia

In essence, Australia's sale of goods legislation provides for property to pass when the contracting parties intend for property to pass. The focus is on the intention of the parties in determining the conditions and at what point property is to pass between the buyer and the seller.

Therefore it is only when the goods have been paid for that there is a clear intention for ownership of the property to pass to the buyer.

New Zealand

The PPSA refocuses attention on the *substance* of the security interest taken in the personal property and not the *form* of the agreement that created the security interest. In addition, priority of a security interest now depends on the registration of a financing statement.

Conflicts rules in the PPSA

The PPSA sets out a regime for determining conflict of law issues. Section 26 contains the residual rule:

- "(1) Validity, perfection and the effect of perfection or non-perfection of a security interest in goods...is governed by the law of New Zealand if, -*
- (a) at the time the security interest attached to the collateral, the collateral is situated in New Zealand; or*
 - (b) at the time the security interest attached to the collateral, the collateral is situated outside New Zealand but the Secured Party has knowledge that it is intended to move the collateral to New Zealand..."*

Application of Conflict Rules

As a general rule, proprietary concerns are almost always referable to *lex situs* (the country in which the goods are located for the time being) and, therefore, proprietary aspects are considered by the law of the same jurisdiction.

Goods sold to a New Zealand buyer but then remain in Australia

The law of *lex situs* is likely to govern whether the reservation of title by the seller is valid and whether title has passed to the buyer in any particular case. Once it is ascertained where title lies pursuant to *lex situs*, the question becomes whether removal to another jurisdiction, pursuant to the law of the subsequent jurisdiction, would override the prior reservation of title in the original *lex situs*.

¹ *Aluminium Industrie Vaasen BV v Romalpa Aluminium Ltd* [1976] All ER 552

The provisions of the PPSA generally respect these established principles. Thus, New Zealand courts would have to recognise that title to goods remained with the Australian seller. This rule must continue to be recognised despite an intention on the part of the buyer prior to its insolvency that the goods be moved to New Zealand (as referred to in section 26(1)(b)).

Goods delivered directly to the buyer in NZ

In this case, the foreign seller who retains title must register its security interest in its goods at the Personal Property Securities Register (**PPSR**).

Goods delivered to the buyer and subsequently moved to NZ

The traditional position has changed with implementation of the PPSA. Section 27(1) requires registration of the seller's interest at the PPSR if the seller's retention of title is to be effective against other secured parties claiming an interest in the goods. If the seller does not register its interest within the specified timeframes, the seller's unperfected interest becomes subordinate to a perfected interest.

Conclusions

The author concludes that the PPSA has enhanced commercial certainty for sellers that retention of title clauses will be upheld in the New Zealand courts.

However, this certainty comes at a price - sellers must enter into an enforceable security agreement and they must also register their interest at the PPSR. In all but a few cases, Australian suppliers of goods to New Zealand buyers will have to register their retention of title arrangements.

It remains to be seen, however, how the New Zealand courts will interpret the rules set out in the PPSA to afford foreign secured parties the presumed protection under the PPSA.

Anti-money laundering and countering terrorist financing

Clayton Cosgrove (Associate Minister of Justice), *LawTalk*, 17 April 2006

This article updates readers on the progress of the regulatory reforms for countering money laundering and terrorist financing, and reassures the legal community about the government's approach to potential compliance costs.

The reforms were summarised in the Spring 2005 issue of *Financial Services Quarterly*.

Submissions have been made on a discussion document circulated last August, and a further round of discussions with stakeholders is now planned. The proposed legislation is expected to be introduced into Parliament early next year.

The article also addresses concerns raised previously in *LawTalk* about the potential compliance costs of the changes, particularly given the costs imposed on lawyers by equivalent regulation in the United Kingdom.

The author seeks to provide some reassurance that the United Kingdom reforms were based on additional European Union directives that are not relevant to New Zealand's obligations, and that *"the government is sensitive to possible compliance burdens for particular sectors arising from these proposals and gives a high priority to minimising those costs wherever possible"*.

Companies Act scores own goal

Alastair Marsden (Associate Professor of Finance at the University of Auckland) and Andrew Prevost (Assistant Professor of Finance, University of Ohio), Competition and Regulation Times, Issue 19, March 2006

This article criticises the Companies Act's directors' duty of care requirement that use of derivatives by companies be monitored. This is because inside directors cannot monitor themselves, and the highly technical language used in derivatives may preclude outside directors from adequately monitoring their use.

Financial derivatives enable companies to hedge or manage foreign exchange risk, interest rate risk and commodity price risk.

However, the authors of this article note that not all hedging is beneficial. Without adequate supervision by the board, managers may invest in projects that enhance their own wealth at the expense of shareholders.

Directors have an important role in monitoring a company's derivatives usage, yet, the Companies Act raised expectations of directors' duty of care, and increased their perceived risk of liability for bad investment decisions.

While this affects all directors, such responsibilities fall disproportionately on outside directors. This is because inside directors cannot monitor themselves, so this monitoring has to be undertaken by outside directors. However, the language of derivatives is highly technical and may not be fully understood by outside directors.

The authors undertook to assess directors' monitoring of derivatives usage. Their analysis showed that, in high-growth firms, the use of derivatives contracts had significantly decreased. They attributed this to the fact that such high-growth firms are characterised by less transparency and greater information advantages for company insiders, making monitoring duties more difficult for outside directors.

The broad conclusion is that the increase in perceived personal liability has caused directors to restrict use of derivatives in the companies where it would be most useful.

Mortgage frauds prompt calls for system changes

Auckland District Law Society Law News, Issue No. 02, 27 January 2006

Major changes to the electronic land registration procedures have been called for following mortgage frauds.

Two Auckland practitioners are calling for major changes to electronic land registration procedures. These calls follow the publicised mortgage fraud perpetrated on ASB Bank. In that case, although the woman's lawyer followed all of the NZLS guidelines in relation to establishing the identity of a new client (i.e. checking the name, photo and signature on the passport), the fraud had still been able to be perpetrated.

A return to the old paper system of duplicate titles is proposed where the person wanting to deal with the title would have to produce the paper certificate of title. This is to mitigate the problems with electronic registration, which places solicitors in control of registering dealings without the involvement of third parties, including Land Registry staff.

Alternatively, the introduction of a triple system modelled on that used by the NZSX has been proposed. Such a security system would require identification of the solicitor, the land owner and the title.

Daddy, are high-yield debentures as safe as houses?

Australian Corporate News, Issue 2, 8 February 2006

This article discusses the growth and risks associated with using funds raised from debenture offerings to the public for mezzanine lending, particularly property developments. There are risks for the mum and dad investors who invest in these debentures and whose funds are then loaned on to companies for specific projects.

Mezzanine finance is effectively defined as the form of finance provided from funds raised by issuing debenture stock to the public. The investments are secured over tangible assets of the company and the terms of the investment generally guarantee capital maturity and interest. In order for the company that issued the debentures to receive a return, the company on-loans the funds, most commonly to property developers.

The loans are attractive to the private borrowing companies who do not have access to the type of fluid capital flow that public companies do. As the mezzanine financier often receives no interest in the borrowing company or the real assets of the borrowing company, mezzanine financing is an attractive option for companies that have exhausted their options with banks and the banks hold the security over the company's assets. So the risk to mezzanine lenders is far greater than to banks, especially as the mezzanine lenders are at the mercy of markets and prices.

ASIC expressed concern that companies offering this type of "high-yield" investments are not sufficiently disclosing the details of the on-lending of the investors' funds or the risks associated with this mezzanine lending. ASIC identified a number of specific problems, including:

- misleading advertising – investment statements inappropriately targeting low risk investors;
- lack of disclosure on related party transactions – the funds are sometimes on-loaned to related parties of the debenture issuer; and
- lack of disclosure of the risks associated with property development, which is the principal use of mezzanine funding.

The authors support a legislative regime with more onerous disclosure requirements.

Comfort letters – a fresh look?

Lang Thai, *Journal of Banking and Finance Law and Practice*, (2006) 17 JBLF 5

This article compares the American and Australian approaches to the enforceability of letters of comfort. The author suggests that the American approach should be adopted in Australia to eliminate the inconsistency in the treatment of letters of comfort cases.

Letters of comfort are used to induce or encourage a lender to provide a loan to a third party and are often drafted in such a way that they do not constitute a guarantee. The author states that they are "*loved by powerful business entities and hated by lawyers and judges. It is neither a true guarantee, nor scrap paper.*"

Traditionally, letters of comfort have been held to be non-enforceable instruments. However, in recent years, Australian courts have showed an increasing willingness to allow enforceability of such letters¹.

In the United States, when the courts are faced with cases concerning letters of comfort, they can apply section 90 of the Restatement (Second) of Contracts 1979 (US). The author asserts that there is a general understanding among the District Courts that, under section 90, a letter of comfort is enforceable if it contains a promise that has been relied on by the recipient and the wording is sufficiently clear to both the issuer and the recipient that they both intended the letter to have legally enforceable obligations.

In addition to section 90, the concept of promissory estoppel is applied differently in the United States - it is used as a substitute for consideration, which is needed in an enforceable document or a contract.

The author notes that there have been four cases heard by the Supreme Court of Australia that specifically refer to letters of comfort. He emphasised that, although the courts in Australia are progressing towards greater support for enforceability of letters of comfort, there is no consistency in their approach. It is suggested that this is because a letter of comfort lacks consideration. The validity and enforceability of letters of comfort therefore depends on the degree of comfort (whether the letter is closer to being a guarantee or just a mere comfort with no contractual force in law).

The author suggests that, in order to overcome the problem with consideration, Australia should either adopt the American version of promissory estoppel or a provision like section 90.

In order to avoid any confusion or argument, Bell Gully's advice is that all letters of comfort specifically state whether or not their content is intended to be legally enforceable.

¹ *Gate Gourmet Australia Pty Ltd (in liq) v Gate Gourmet Holding AG* [2004] NSWSC 149 and *Banque Brussels Lambert SA v Australian National Industries Ltd* (1990) 21 NSWLR 502

Age discrimination and bank lending

Andrew Shann, LawTalk, 17 April 2006

This article considers implications of the prohibition on age discrimination contained in the Human Rights Act 1993 for bank lending.

In practice, banks will often look at the age of a prospective borrower when considering the terms of any credit. For instance, a bank would generally be unwilling to lend beyond a person's expected working life or life expectancy.

However, no specific exception for the provision of credit has been introduced in respect of the Human Rights Act's prohibition on age discrimination.

There is a general exception where there is deemed to be "*genuine justification*", but the only ruling to date on that exception was a case allowing differential rental car charges based on the age of the hirer. The question of whether the general exception would also apply to differential treatment of applications for credit remains untested.

A specific exception does exist in the Australian age discrimination legislation for the provision of credit, and the author believes that this may strengthen the case for the New Zealand "*genuine justification*" exception to apply to age discrimination in bank lending. However, in the author's view, banks currently have to face the risk that they are violating the Human Rights Act by considering factors that are particular to elderly borrowers.

Mr Shann is looking at making a submission to the Justice & Electoral Committee seeking an age exception for the provision of finance the next time the Human Rights Act comes up for review.

Smart card technology rejected

Peter Ryan, Australian Banking and Finance, Volume 15, Number 3, 2006

Smart card technology rejected because "there is nothing wrong with cash".

In an article entitled "CIO's rate security No. 1 tech challenge", Mr Ryan referred to a speech given by John Loebenstein to the Australian Banking and Finance CIO Outlook Luncheon in Sydney.

Mr Loebenstein, CIO at St George Bank, said that trials with smart card technology in Australia, the United States and the United Kingdom have been overwhelmingly rejected by customers for the simple reason that there is nothing wrong with cash.

Legislation/In Parliament

Securities Legislation Bill – discussion document released

A discussion document on the Securities Legislation Bill was released by the Ministry of Economic Development in March.

The document addressed regulation in the following areas:

- investment advisers' and brokers' disclosure;
- substantial security holders' disclosure;
- insider trading exemptions; and
- market manipulation exemptions.

It is anticipated that the Securities Legislation Bill could go through its final legislative stages in the next few months. Submissions on the proposed regulations were due on 5 May.

Review of financial products and providers - update

A review of financial products and providers (RFPP) is currently being undertaken by the Ministry of Economic Development (MED).

It is currently in phase 2, which involves the development of options for reform. Advisory groups have been established, and the options for reform are being tested on these groups. The outcome of these tests will result in a public consultation paper, which is expected to be released in July or August. There will be an opportunity for submissions on the paper and then further consultation. The MED is also interested in the input of parties not selected on the RFPP advisory groups, and encourages submissions.

An inter-departmental review on domestic institutional arrangements (**DIA Review**) is also underway. The DIA Review is being lead by Treasury and involves the MED, the Securities Commission, the Reserve Bank of New Zealand and the Ministry of Justice. At the end of 2005, Cabinet agreed with the principal decision of the DIA Review that there should be one prudential regulator for the New Zealand financial sector and that the regulator be the Reserve Bank.

A final report back in respect of the DIA Review is scheduled for November 2006.

For more information, see the MED business news website: <http://news.business.govt.nz>

Significant changes planned for taxing offshore investments

The Government has introduced to Parliament a Bill to revise the rules for the taxation of investment income of New Zealand investors.

The proposed rules significantly change the way that offshore investments held by New Zealand investors are taxed and introduce a new regime for Portfolio Investment Entities (**PIEs**).

Tax on 85% of capital gains on most offshore portfolio investments

The revised rules offer a choice of methods for taxation of portfolio investments (investments of less than 10%). However, the most concessional rule available to most investors (the Smoothed Market Value Method) will tax 85% of all capital gains on portfolio investments in foreign companies (with the exception of investments in Australian companies listed on the ASX) on an unrealised basis. There is an exemption from the revised rules for individuals (not acting as trustees except in limited circumstances) if the original cost of the investor's portfolio is less than NZ\$50,000.

Investors will be taxed on 85% of the growth in value of their investment plus any dividends, although the investor's tax liability will potentially be spread across a number of years. Each year the investor will be required to pay tax on 5% of the value of the investment at the start of the year (or more if the investor receives more than a 5% return in cash by way of dividends and sale proceeds), unless the total of growth plus dividends is less than 5%. On realisation, the investor will be required to pay tax on the portion of the 85% growth in value that has not previously been taxed. However, rollover relief will allow individual investors to sell one offshore share parcel and purchase another without being taxed in that year on any carried forward gains that have not yet been taxed.

A decrease in the value of an investment will be recognised as a loss for tax purposes in the same manner as gains are recognised as income. This means that the loss that is actually allowed in the year will be limited to 5% of the opening value of the investment with any unutilised loss deferred until realisation.

The Smoothed Market Value Method allows investors will have the option of pooling their offshore investments for the purposes of the new rules rather than applying the rules to each individual investment. Investors that are pooling their offshore investments will still be required to value their offshore investments at the beginning of the year to calculate the 5% cap for that income year.

Alternative methods

Market value method

Under this method, all offshore interests for which this method is selected will be treated as a pool. Dividends will be fully taxable (and grossed up for foreign non-resident withholding tax with a credit allowed for three amounts) and 85% of any capital gains (on an unrealised basis) on shares outside the NZ\$50,000 threshold or the exemption for New Zealand shares or Australian listed shares will be taxable. The difference with this method is that there is no 5% cap on income or losses.

Cost method

Under this method, each investment must be separately accounted for. The investor will be taxed, annually, on the higher of 5% of opening value or dividends and, on realisation, on 85% of the difference between the sale proceeds and the opening tax value.

Branch equivalent method

The branch equivalent method set out in the current foreign investment fund rules will continue to be available to investors as an alternative to the new rules. Under this method, profit or loss in the foreign company (calculated under New Zealand tax rules) is attributed to the investor in proportion to their interest in the company. Investors applying the branch equivalent method under the current rules are not taxed on gains on the sale of their investments. Applying this method can be a difficult task for portfolio investors from a compliance perspective. It requires that an investor has access to detailed information about the offshore company in order to calculate New Zealand equivalent income or loss.

Accounting profits method

The accounting profits method set out in the current foreign investment fund rules will continue to be available as an alternative to the new rules. It taxes investments in foreign companies by calculating an investor's share of the underlying after-tax accounting profit of the foreign company.

Specific rules may apply where there is a switch between income calculation methods.

Exemption for Australian listed companies

Investors will not be required to apply the new rules to investments in Australian companies listed on the ASX (the cost of those investments are also excluded from the \$NZ50,000 threshold). This may also include listed unit trusts deemed to be companies for New Zealand tax purposes.

If the revised rules do not apply investors will continue to pay tax only on dividends if they hold the shares on capital account (meaning they do not actively trade these interests and did not acquire the interests with a purpose of resale).

PIE regime

"Flow-through" tax treatment

Currently, managed funds are taxed on income at 33%. A managed fund that elects to be a portfolio investment entity (PIE) will be given "flow-through" tax treatment. PIEs will be required to pay tax on an investor's share of PIE income:

- at 19.5% if the investor is an individual that earned less than \$48,000 in the previous year;
- at 33% for all other individual investors; and
- at 0% if the investor is a resident entity investor (such as a New Zealand resident company, New Zealand unit trust or deriving income as a trustee) but the investor will have to include the share of income in their own tax return.

The tax paid by the PIE will be a final tax for individual investors in most cases. Individual investors taxed at 39% will benefit from a 6% tax saving.

Exemption for gains on sale of shares

Gains derived by a PIE (in most cases currently taxed at 33%) on the sale of shares in New Zealand companies and listed Australian companies will be exempt. The exemption will allow investors in PIEs to receive tax-free capital gains on the sale of those shares, regardless of how regularly shares are traded.

Offshore investments

PIEs will have to use one of the 5 methods outlined above (*Smoothed Market Value Method, Market Value Method, Cost Method, Branch Equivalent Method or Accounting Profits Method*) to calculate tax on offshore investments that are not investments in listed Australian companies.

Qualifying funds

Broadly, a managed fund can elect to become a PIE if the fund:

- carries on the principal activity of providing savings and investment services by deriving certain types of investment income;
- has a minimum number of investors;
- is a "portfolio" (non-controlling) investor (subject to limited exceptions);
- has issued one class of units (this will need to be determined having regard to applicable definitions in the current tax rules); and
- is tax resident in New Zealand.

Defined benefit superannuation schemes will also be able to elect into the new regime but will pay tax at 33% on their income rather than based on investors' tax rates.

Notional wind-up on entering regime

At the time that a managed fund makes an election to enter the regime, the fund will be deemed to dispose of its assets and reacquire them at market value for tax purposes. For most funds, this deemed disposal will trigger a tax liability on investments held by the fund. This tax liability can be spread over three income years.

What next?

The new tax Bill was introduced on May 17 this year. There will be opportunities to make submissions before the select committee. If implemented, the new rules will apply from 1 April 2007.

Financial intermediaries: Cabinet agrees to co-regulatory model

Cabinet has agreed to the adoption of a co-regulatory model for regulation of financial intermediaries, where industry-led "approved professional bodies" and the Securities Commission will work together to regulate financial intermediaries.

This model was recommended by the Financial Intermediaries Task Force in their final report. The design of the model is to be carried out by the Ministry of Economic Development (**MED**).

The time frame for implementation of the model is:

- First half of 2006 – discussion paper to be released, inviting public comment.
- Mid to late 2006 – Cabinet approval will be sought to start the process of incorporating the detailed policy proposals into a draft Bill.
- Aim to pass legislation in 2007/2008.

The MED is currently preparing a discussion document on the details of the co-regulatory model and is aiming to release it in June. Some issues that are likely to appear in the discussion document are:

- suggested definitions of financial intermediaries, and how they will work in practice;
- "single employer entities" and the co-regulatory model; and
- dispute resolution options.

For more information, see the MED website: www.med.govt.nz

Financial Reporting Act review

Reform of the Financial Reporting Act is scheduled to take place in December.

This will reduce business compliance costs, especially for small and overseas companies.

A Bill is to be introduced in the next few months, with a view to enactment of the legislation by the end of the year.

For more information, see the Ministry of Economic Development's business news website:
<http://news.business.govt.nz>

Trans-Tasman taskforce takes up the fight against scams

The Australasian Consumer Fraud Taskforce has launched a trans-Tasman campaign to inform consumers about the most common types of scams and how to recognise whether an offer is genuine or false.

Key characteristics for consumers to look out for in identifying a scam include:

- it comes out of the blue;
- it sounds like a quick and easy way to make money;
- it tells you there is almost no effort or risk; and
- it sounds just too good to be true.

The Ministry of Consumer Affairs operates the *Scamwatch* website, www.scamwatch.org.nz, which provides consumers with information on types of scams currently operating.

A list of top scams for 2005 were identified by the Commerce Commission and the Ministry of Consumer Affairs. Included in the list was *phishing* which is the name given to the process where criminals send emails pretending to be a bank in an attempt to obtain personal details and passwords from the recipients.

Ministers announce key achievements in the trans-Tasman single economic market agenda

A number of measures have been announced to accelerate moves to remove barriers between the New Zealand and Australian economies:

- A treaty on Mutual Recognition of Securities Offerings has been signed. This will form the underpinning for a scheme that will allow an offer of securities to be made in both countries in the same manner and with the same offer documents.
- A new Memorandum of Understanding on Business Law Coordination has been signed.
- Both Governments have committed to implement the recommendations of the first report of the Joint Trans Tasman Council on Banking Supervision and to legislate amendments to facilitate information sharing between the competition regulators in both countries. These changes will require the banking supervisors to support each other and consider the impact of their actions on the financial system stability in the other country.

In a joint press statement, New Zealand and Australian Treasurers announced the agreement of the Australian and New Zealand governments to legislate the changes recommended by the Joint Trans-Tasman Council on Banking Supervision.

The changes focus on:

- general provisions that require each regulator to support the other in fulfilling their statutory objectives;
- requiring regulators to consult each other before exercising a power that could cause instability to the other country's financial system, especially "detrimental actions" that interfere with, or prevent, the provision of outsourced services to parties in the other country; and
- requiring administrators and statutory managers to advise the regulator if they have reasonable cause to believe that a proposed exercise of a function/power by them is likely to adversely affect the other country's financial system.

Review of the redress and enforcement provisions of consumer protection law

The Ministry of Consumer Affairs has published an international comparison discussion paper comparing our Fair Trading Act 1986 (FTA) and Consumer Guarantees Act 1993 with the consumer protection legislation in Australia, Canada, the United States and the United Kingdom.

The overall finding is that the redress and prohibition provisions in our consumer protection legislation are very similar to those in the other jurisdictions.

However, the report outlines a number of additional prohibition, investigation and enforcement tools and penalties that might strengthen the FTA by improving outcomes for consumers and businesses.

For example, a prohibition on unfair terms in consumer contracts and a requirement for product safety warning notices.

The Ministry suggests that these measures will:

- assist the Commerce Commission to act more effectively and efficiently when it identifies a contravention;
- provide better protection for consumers and allow them to transact with more confidence; and
- enable compliant businesses to compete more fairly.

Recent developments

Securities Commission reviews financial reports

The Securities Commission is carrying out an ongoing financial reporting surveillance programme to review the reporting practices of issuers, with the aim of encouraging New Zealand issuers to improve the quality of their financial reporting.

Two cycles of this surveillance have now been completed. The report setting out the findings for cycle 2 was published in February.

The findings are similar to those of cycle 1 in that few serious problems were identified, but a number of issuers need to raise the standard of their financial reporting. The report on cycle 1 was not available prior to the financial statements reviewed in cycle 2 being prepared.

The reports of 46 issuers were reviewed against NZ GAAP. 19 issuers had matters that needed to be addressed, with the following significant matters arising several times:

- the format of the "Statement of Movements in Equity" was incorrect;
- failure to date and/or sign the financial statements; and
- inadequate actual versus prospective financial information comparisons.

Issuers have been given three years to switch to International Financial Reporting Standards (**IFRS**). At present, issuers can choose between the current system and IFRS.

The Commission is reviewing the financial statements of a selection of issuers who have chosen to comply with IFRS already, aiming to provide feedback to the Commission so that it can better educate parties in respect of IFRS and better enforce IFRS.

For more information, see the Securities Commission website: www.sec-com.govt.nz

Bank capital, risk management and the economy

In a speech given by the Deputy Governor and Head of Financial Stability of the Reserve Bank of New Zealand, Adrian Orr, the focus was on implementation of the new Basel II capital adequacy framework.

Implementation of the new Basel II capital adequacy framework is one of the major banking regulation initiatives the Reserve Bank is currently undertaking. The driving forces behind the Basel Accord and its inherent risks and benefits were summarised in the Spring 2005 issue of *Financial Services Quarterly*.

Background

The soundness and effectiveness of banks is significant for financial stability in New Zealand because:

- a relatively large proportion of financial activity in New Zealand involves banks (as a crude measure, three quarters of all financial assets held in New Zealand are held in banks); and
- New Zealand is heavily reliant on foreign investment, and banks are the primary means by which the demands of domestic borrowers are met by foreign lenders.

The Reserve Bank has important duties and functions regarding financial stability in New Zealand. In fulfilling its duties and functions, the Reserve Bank has used a mix of policies that:

- promote effective governance by banks' boards of directors;
- strengthen market scrutiny of banks; and
- set certain minimum standards of risk management by banks.

Although these approaches work well in normal economic circumstances, they are not effective in times of economic stress or shock.

Capital adequacy and Basel II

The focus of capital adequacy is not on favourable economic conditions but on unexpected loss associated with severe downturns in the economy's performance.

The concept of capital is the cornerstone of effective risk management by banks. The Reserve Bank's implementation of Basel II is focused on making capital requirements more sensitive to risk, and particularly risks specific to the New Zealand environment.

Basel I established two basic principles:

- banks should hold capital of certain quality and above certain levels at all times; and
- these levels should take account of the risks banks face.

The main principles under Basel II are:

- that a bank's minimum capital requirements should be better aligned to the risks that the bank is taking; and
- that supervisors should allow banks to use their own internal statistical models and processes to calculate their minimum capital requirements provided that the internal models and processes meet certain minimum quality requirements (if a bank does not use internal models, it will use a standardised approach that links minimum capital requirements to external measures of risk).

Basel II is not intended to result in significant changes in the level of capital in the banking system overall. It is aimed at creating minimum levels for an individual bank more sensitive to the risk of unexpected loss faced by that bank.

The regulatory capital requirements for banks incorporated in New Zealand will be calculated under Basel II from January 2008.

Accreditation

If a bank wants to be accredited to use its own internal models to calculate minimum capital requirements, it will need to submit an application to the Reserve Bank by July this year.

Because housing loans make up the largest part of banks' exposures in New Zealand, a key focus for the Reserve Bank in deciding whether to accredit a bank will be on how the bank's proposed internal model approach addresses the bank's credit risk exposure to housing loans.

Implementation

The Reserve Bank's programme of engagement with banks on Basel II is well underway.

As part of the implementation of Basel II, the Reserve Bank will be working with the relevant foreign supervisors of banks that are members of international banking groups.

Mr Orr highlighted that communication with the Australian Prudential Regulation Authority (**APRA**) will be particularly important because of the significant number of banks in New Zealand owned by Australian parent banks. Terms of Engagement have already been put in place between the Reserve Bank and APRA.

In implementing Basel II, the Reserve Bank aims to:

- achieve a greater risk-sensitivity in capital requirements; and
- highlight the need for levels of bank capital to be held stably and sustainably at sufficient levels to account for unexpected loss.

Bell Gully news

Bell Gully named New Zealand Law Firm of the Year

Bell Gully has been named *IFLR* New Zealand National Law Firm of the Year for the third consecutive year. It is the fourth time in five years that the firm has received the prestigious award from respected global legal publisher *International Financial Law Review*. The annual *IFLR* awards recognise the leading legal advisers in international corporate and financial transactions over the past year.

Bell Gully named New Zealand's *Who's Who Legal* Firm of the Year

Bell Gully has been named the *Who's Who Legal* Law Firm of the Year for New Zealand in the 2006 *Who's Who Legal* Awards. Based on nominations received from clients and other practitioners, *Who's Who Legal* has identified pre-eminent firms in 47 countries to receive their country's award. *Who's Who* managing editor Callum Campbell says: " This is the first time we have singled out an individual firm nationally for such an honour, and Bell Gully can truly be said to be New Zealand's leading firm."

For further details and more news visit: www.bellgully.com

Useful Web links

New Zealand government

- Consumer affairs [www.consumeraffairs.govt.nz]
- Inland Revenue Department [www.ird.govt.nz]
- Ministry of Economic Development [www.med.govt.nz]
- Ministry of Foreign Affairs and Trade [www.mfat.govt.nz]
- New Zealand Government [www.govt.nz]
- NZ Government E-Commerce Information [www.ecommerce.govt.nz]
- NZ Treasury [www.treasury.govt.nz]
- Office of the Clerk of the House of Representatives [www.clerk.parliament.govt.nz]
- Parliamentary Counsel Office [www.pco.parliament.govt.nz]

New Zealand financial agencies and organisations

- Commerce Commission [www.comcom.govt.nz]
- The Companies Office [www.companies.govt.nz]
- Export Credit Office [www.treasury.govt.nz/exportcreditoffice]
- NZ Law Commission [www.lawcom.govt.nz]
- Office of the Banking Ombudsman [www.bankombudsman.org.nz]
- Office of Insurance and Savings Ombudsman [www.iombudsman.org.nz]
- Office of the Privacy Commissioner [www.privacy.org.nz]
- Personal Property Securities Register [www.ppsr.govt.nz]
- Reserve Bank of New Zealand [www.rbnz.govt.nz]
- Securities Commission [www.sec-com.govt.nz]
- Takeovers Panel [www.takeovers.govt.nz]

New Zealand commercial sites

- CLANZ [www.clanz.org]
- Financial Services Federation [www.fsf.org.nz]
- Institute of Chartered Accountants [www.icanz.co.nz]
- NZ Bankers' Association [www.nzba.org.nz]
- NZ Business Roundtable [www.nzbr.org.nz]
- NZ Institute of Economic Research [www.nzier.org.nz]
- NZ Exchange [www.nzx.com]

Australian government sites

- Banking Ombudsman [www.abio.org.au]
- National Office for the Information Economy [www.ogo.gov.au]

Australian commercial sites

- Australian Financial Markets Association [www.afma.com.au]
- Australian Securities and Investment Commission [www.asic.gov.au]
- Australian Stock Exchange [www.asx.com.au]

International sites

- Bank for International Settlements [www.bis.org]
- Global Banking Law Database [www.gbld.org]
- International Monetary Fund [www.imf.org]
- International Swaps and Derivatives Association [www.isda.org]
- NASDAQ [www.nasdaq.com]
- New York Stock Exchange [www.nyse.com]
- United States Securities and Exchange Commission [www.sec.gov]
- World Bank [www.worldbank.org]