

## The Basis Capital decision

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On 28 July 2008, Austin J delivered his judgment in the matter of *Basis Capital Funds Management Limited as Responsible Entity of the Basis Yield Fund and Basis Aust-Rim Diversified Fund v BT Portfolio Services Limited & Ors* [2008] NSWSC 766. The judgment has practical implications for a number of funds, in particular those which operate on the basis of a periodic application cycle, many of which may find that one of the key legal assumptions that underpin their mode of operation has now been held to be false. The decision addresses the legal effect of the way in which units in registered schemes are issued and redeemed, and as such will be of particular interest to responsible entities, fund administrators and the back office. The fact that breaches of the relevant provisions in the Corporations Act can potentially attract criminal penalties means that directors of responsible entities should also pay close attention to the decision.

### Summary

The decision looks in particular at the effect of section 1017E of the Corporations Act, and it is here that many fund operators may find that the decision gives cause for concern.

In short, section 1017E requires a product provider to pay application moneys into a special account. The product provider must either return the money or issue the product within a period of one month from receipt, unless it is not reasonably practicable to do so.

Austin J held that:

- (a) where units are to be issued at net asset value, it could not be said that units are issued in the absence of calculations revealing the number of units to be issued – in other words, there can be no legal issue of units until net asset value for the relevant dealing day has been struck;
- (b) on the relevant dealing day, however, applicants received an "interim" product, namely a contractual right to have units issued to them. This "interim" product is to be distinguished from actual units in the fund, and the "interim" product is not therefore the product (as referred to in section 1017E) which was applied for when the applicant sent their application money; and
- (c) the time extension provided for in section 1017E applies only where it is not reasonably practicable either to return the money or issue the product.

The effect of the decision is to say that application money received by a fund remains application money for the purposes of section 1017E until such time as the fund is able to strike net asset value, calculate the number of units to be issued and the back office takes the steps necessary to demonstrate that units have been issued (updating registers, for example). Ordinarily, this process takes just a few business days beyond the relevant dealing day, and there should not be a problem with the one month period. Where however the process is delayed, the fund runs the risk that it ends up holding application money for a period of one month. Under these circumstances, the time extension in section 1017E will not apply where it is reasonably practicable to return the application money. In general, it is difficult to see circumstances in which it would not be reasonably practical to return application moneys, so that the legal obligation is then to return application monies.

### Background

The Basis Capital case was brought in order to resolve the competing claims of four categories of investors in two Australian registered managed investment schemes – the "Basis Yield Fund" and the "Aust-Rim Diversification Fund" (together, the **Funds**). The proceedings were initiated by Basis Capital Funds Management Limited (**BCFM**), the responsible entity of the Funds.

The Funds, between them, received over \$23m in application money in June 2007 in respect of the dealing day falling at the end of June. In the normal course, units would have been issued to the

applicants (**June Applicants**) in early July, once BCFM's accountants calculated the net asset value per unit as at 30 June 2007.

Further, 30 June 2007 also marked the end of a quarterly redemption cycle for each of the Funds. As at 30 June 2007, a number of investors (**June Redeemers**) had validly submitted redemption requests.

In the event, the disruption of global credit markets impacted negatively on the Funds' exposure to asset-backed securities. Consequently, BCFM announced a suspension of redemptions on 16 July 2007 and was unable to calculate the net asset value of the Funds as at 30 June 2007 (for the purposes of the June applications) until late September 2007. Meanwhile, some of the June Applicants had sought to withdraw their applications and to obtain a full refund of their application money.

This situation gave rise to a number of issues, in particular:

1. ***Could the June Applicants call for repayment in full of their application money, or should they be allocated units valued as at 30 June 2007 (by the valuation made at the end of September 2007)?***

The June Applicants argued that as the net asset value per unit was only calculated at the end of September 2007, BCFM could only have issued units to them at that time. In the period between receipt of their application money and the actual issue date, BCFM was required to comply with section 1017E of the Corporations Act and hold the application moneys in trust for the June Applicants.

On this question, Austin J upheld the claim of the June Applicants. This was based on a finding of fact as to when the new units were issued to the June Applicants. In Austin J's view, nothing happened on 2 July 2007 that could be regarded as the issuing of new units either by BCFM or the funds' administrator (as BCFM's agent) and that in the absence of calculations revealing the number of units to be issued, it could not be said that on that day, units were issued.

Interestingly, this was despite the fact that when the number of units was eventually calculated, the issue of units was expressed to take effect as from 2 July 2007.

Section 1017E places an obligation on the product provider either to return the application money, or to issue the financial product (in this case, units in the Funds), within one month of receipt of the application money, unless it is "not reasonably practicable to do so". Austin J considered that:

- the permitted time extension applies only where it is not practicable to do either of the options (ie refund the money or issue the financial product) within one month; and
- as at 2 July 2008 and pending the actual issue of units in the Funds, although a type of financial product had been issued (namely a contractual right to have units issued to the June Applicants), this was not the relevant financial product for section 1017E purposes.

Accordingly, since units were found not to have been issued within the prescribed one month period, Austin J declared that BCFM holds the application monies in trust for the June Applicants under section 1017E and is therefore obliged to return the monies to the June Applicants.

2. ***Were the June Redeemers entitled to be paid out the value of their units, calculated as at 30 June 2007?***

The June Redeemers argued that their redemption requests should be honoured, because although the Funds later ceased to be liquid for the purposes of the Corporations Act, they

were liquid schemes as at the dates that the redemption requests were lodged and as at 2 July 2007 (ie the date on which BCFM was obliged to redeem the units).

It is apparent from this part of the judgment that the Corporations Act, as it applies to redemptions, is less prescriptive than in the provisions dealing with money received for financial products before the products are issued. Austin J's decision therefore largely turns on the construction of the regime for redemptions set out in the Funds' constitutions.

Austin J concluded that the June Redeemers had validly exercised a redemption right and were therefore entitled to have their units redeemed, and to payment of the redemption proceeds, calculated as at 30 June 2007. The provisions included in the constitution allowing deferral and suspension of redemptions could not be exercised after a particular dealing day (in this case, 30 June 2007) had passed to defeat the rights of members who had previously validly exercised a right to have their units redeemed as at that dealing day.

Accordingly, the June Redeemers were entitled to have their units redeemed as at 30 June 2007.

### Observations

- It is possible that there are product providers operating on the assumption that they are entitled to hold application moneys for longer than one month where it has not been feasible or possible to issue units within one month of receipt. This assumption is incorrect because in most cases, it will be reasonably practicable to refund the money where units cannot be issued. As a result, the application moneys will generally need to be returned if the product applied for cannot be issued within one month of receipt of the application money.
- The one month time frame for issuing products could in some situations be very restrictive and Austin J's interpretation of section 1017E may be problematic in these circumstances. This issue may prove particularly acute, for example, during an initial offer period where a fund's launch is subject to attaining a minimum subscription level, or for established funds which operate on a monthly or longer dealing cycle. Product providers may need to review the manner in which the fund is operated to ensure that application moneys are not received so far in advance of launch or a dealing day that the one month period from receipt will be reached.
- Austin J made it clear that an "interim" financial product (i.e. a contractual right to have the product applied for issued) is issued on the dealing day. Funds may wish to consider taking legal advice to see whether it may be possible to re-structure the terms of their offering to make it clear that applicants are applying for this "interim" product (rather than just for units in the fund) which then in effect converts into actual units once net asset value has been struck. It may be possible in this way to bring the s.1017E one month period to a close on a dealing day notwithstanding that the number of units to be issued has not yet been calculated, although it is likely that a range of other issues (for example, regulatory or tax) will also need to be considered in connection with the implementation of a proposal like this.
- The decision leaves unanswered the question of the legal nature of the "interim" financial product and whether, for example, the deemed issue of it gives rise to any regulatory considerations or obligations. It is also unclear how this "interim" product is categorised for the purposes of authorisations to be obtained under an Australian Financial Services Licence.
- Issuers may look for other ways of structuring or issuing their products to try to overcome the effect of the decision. For example, issuers may be able to issue units based on a pre-set issue price or on an approximate issue price, with appropriate adjustment mechanisms applying once a more accurate price can be struck. Alternatively, it may be possible to implement alternative techniques to defer the payment of the application monies by applicants until closer to the anticipated issue date.

- Making any changes to the structural or operational aspects of a fund will require advice from a fund's legal advisors and other affected service providers. For example, the fund's PDS or offering memorandum and its constitution are likely to require amendment, and the administrator, registrar and transfer agents will need to ensure that their systems are able to accommodate the changes.

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