24 April 2002

Mr John Kluver
Executive Director
Corporations and Markets Advisory Committee
GPO Box 3967
SYDNEY NSW 2001

Initially by email to: john.kluver@asic.gov.au

Dear John

CAMAC Insider Trading Discussion Paper

The Australian Financial Markets Association (AFMA) would like to thank the Corporations and Market Advisory Committee (CAMAC) for its encouragement to make a submission for its inquiry into insider trading. Also, thank you for presenting at the AFMA Seminar "FSR: An Industry in Transition" on Thursday 11 April. The date was chosen to be one month after the implementation date of the FSR laws, and it is clear that your presentation was well received.

AFMA represent the participants in the over-the-counter (OTC) financial markets, a new industry sub-sector to the ongoing Insider Trading debate. AFMA and our members are coming to grips with the effects of the unilateral widening of the Insider Trading offences through FSR to all OTC transactions which took effect without transition on 11 March 2002. The turnover of the OTC financial markets dwarfs that of the exchange markets in overall size and growth. In the fiscal year to 30 June 2001, OTC financial markets contributed A$31 trillion, or 72%, of all financial markets turnover. The growth in the OTC markets was 13.5%. A summary of all Australian financial markets turnover is attached in the Appendices.

The FSR insider trading provisions put this vibrant and healthy sector of Australian financial markets at risk of flight to more favourable jurisdictions. Where trading cannot move overseas, there is a strong possibility that the efficiency of the OTC financial markets will be impaired by laws designed for public retail access markets. Accordingly, the issue of insider trading is very important to Australian OTC financial markets and dealers.

We believe that the FSR formulation of insider trading laws – particularly to the over the counter (OTC) markets - is unique in the world. We believe that the laws, which have application to global trading which occurs in Australia, are very different in scope to those applicable in other jurisdictions and will expose Australia to the scrutiny in view of the experimental nature of the approach being adopted. The world's financial services regulators, particularly those in our timezone who look to Australia for leadership, will be watching to see what affect the Laws will have on market efficiency, enforceability, market abuse, and market participants.

The Australian Financial Markets Association submits the following solutions for consideration:

1. Limit insider trading to prescribed financial markets (such as FSR Regulation 7.1.01); and,
2. Limit insider trading to listed products; and,
3. Re-define what constitutes inside information for the purposes of different markets (particularly OTC financial markets).

These proposals are not inconsistent with the UK FSA Code of Market Conduct, which recognizes the differences between different markets and participants.

It is particularly difficult to combat all the issues and legacy of insider trading, as it applies to OTC trading in a single submission. The FSR Task Force would be pleased to provide further supplementary submissions to assist in CAMAC's deliberations. Additionally, the members of the AFMA FSR Task Force have indicated their willingness to meet directly with CAMAC or the CAMAC legal committee to discuss any matter relevant to this submission. One subject that is too vast to write into a submission, but may be worthwhile for CAMAC is the operations of the OTC financial markets and the differences between the OTC and the traditional licensed financial markets.

This submission also includes as appendices:

- Members of AFMA
- Members of the AFMA FSR Task Force
- Selected comments on the issues raised in the CAMAC Insider trading Paper

The Electricity trading members of AFMA are preparing a special submission on the application of FSR Insider Trading laws to electricity derivatives trading, and particularly by the producers of electricity. That submission is nearing completion.

Please feel free to contact me on the numbers listed below.

Yours sincerely

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Director, Policy & FSR Consulting

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Postscript:
"Mit Geduld und Zeit ,wird sich der tiefe Geistigernebel über Insiderhandel auflösen"

"The amendments (to the Insider Trading Laws) demonstrate the Government's willingness to refine the law where unintentional barriers to business may have emerged. We are set on having a flexible, pro-business approach without compromising the integrity of the legislation and making sure implementation goes smoothly for all stakeholders."

Senator Ian Campbell, Parliamentary Secretary to the Treasurer, 25 March 2002

Introduction

The Australian Financial Markets Association (AFMA) is of the view that it is appropriate for different types of markets to have different rules depending upon the nature of the market, it's participants and the products traded. In the case of OTC financial markets the participants are predominantly sophisticated institutions which have an intimate knowledge of the market, it's risks and other participants. It is crucial to note that insider trading has not been considered an issue in respect of OTC financial markets prior to implementation of FSRA in Australia or elsewhere. As you are aware, prior to implementation of FSRA, OTC financial markets (other than bonds) were not subject to insider trading laws. The general lack of insider trading laws for OTC financial markets prior to FSRA did not result in a perception that insider trading occurred in OTC financial markets or was a problem in any way. By contrast it is generally accepted that insider trading can be a problem and ought to be regulated in exchange traded environments where retail participants have significant involvement. Some of the reasons why insider trading is not a significant issue for OTC financial markets include that participants on OTC financial markets are usually highly sophisticated, understand the way in which the markets work (including in some circumstances the existence of information asymmetry), often have ongoing commercial relationships which depend on maintaining positive reputations and place a premium on maximum flexibility in their markets. In other words, participants in OTC financial markets generally choose to accept less regulation in exchange for speed and flexibility, in this regard I refer to the comments about transparency levels made under the heading "Market Microstructure Research" below.

In simple terms AFMA's view is that insider trading was not an issue for OTC financial markets prior to FSRA. Consequently, the imposition of insider trading laws on OTC financial markets is the equivalent of applying a remedy where there is no ill. If the application of insider trading laws to OTC financial markets merely solved no problems, AFMA would not object, however, there are also negative consequences of the application. Negative consequences, include additional compliance costs, the potential for markets to close down if key players can not trade for certain periods and the creation of a perception by global firms that Australia is a difficult jurisdiction in which to operate. For example, most OTC financial markets do not have any centralised information distribution infrastructure, therefore once inside information is received it would be difficult to make it public in an effective manner, so if a participant receives inside information when it holds open positions, is a market maker or otherwise would have been trading, the participant would be required to cease operations and potentially incur significant damage until it is able to cleanse itself. In the absence of any offsetting benefits from the application of the insider trading laws to OTC financial markets, these negatives have the potential to make Australia a disadvantageous jurisdiction in which to operate.

Application of insider trading to the pre-FSR laws

The AFMA FSR Task Force has considered the application of Insider Trading to OTC financial markets in the pre-FSR Corporations Law.

While it can be argued that the pre-FSR insider trading laws included OTC transactions, we believe that such a position is an overly literal interpretation of the laws. Any inclusion of OTC financial transactions in the Insider Trading provisions would have been unintended and incidental and not in response to any policy setting of which we are aware. The pre-FSR Insider Trading laws were formulated without any consideration of OTC transactions, and were never challenged by industry as they were never considered to apply OTC transactions. It is arguable that they were never prosecuted because:

1. There were no offenders or offences brought to the attention of the regulator which required prosecution (which would indicate requirement for no further regulation); or,
2. There was no intention to prosecute OTC transactions because of their unintended and incidental inclusion; or,
3. The insider trading laws were not enforceable in the OTC markets, as they were designed for authorized markets.

OTC financial markets with no requirement, or mechanism, for disclosure.

One criticism of the FSR Insider Trading laws regards Insider Trading as an information question. In other words, the critique approaches the concept of insider trading from an alternate position. That position is one where Insider Trading is an offence against the normal operations of a disclosure regime, which is understood and expected by the market participants. The issue with the FSR insider Trading laws is that it has extended the laws that relate to the retail public access, exchange-based disclosure regime to products, participants, and markets that do not have a disclosure regime. It is inappropriate to have an offence for not disclosing in markets that have and expect to have no disclosure requirement, and no disclosure mechanisms.

The OTC market does not have a mechanism to ensure that material information is disclosed to the market on a timely basis as is the case with a listed exchange such as the Australian Stock Exchange which has a CAP platform. Therefore if a participant has inside information there is no mechanism available to ensure that information which should have made generally available can be made available to the market. This would result in a breach of the insider trading regime.

The case for excluding over the counter financial markets and products from the insider trading law

The members of the AFMA FSR Task Force consider that the FSR insider trading provisions may not be pro-market efficiency for the purposes of OTC financial markets transactions between non-anonymous, private non-retail parties. It is arguable that the FSR Insider Trading Laws are anti-efficiency for the participants of the OTC markets, as they have the potential to discourage participation or active risk management.

The issue with the FSR laws, and their application of functionally uniform regulation, is that only one market microstructure has been considered – that of a retail-transparency based public-access markets – such as the Australian Stock Exchange. The former Chapter 7 provisions have been applied to the public-access futures markets and all other financial

markets. The concept of "able to be traded on a financial market" has been extended from the pre-FSR formulation relevant to authorized markets, to all financial markets regardless of whether the financial market is operated centrally or not; and regardless of whether the financial market requires licensing or not.

Market Microstructure research

The market microstructure research of Professors Maureen O'Hara, Vernon Smith, and Charles Plott, uphold the FSA Code of Market Conduct where it says:

> "The extent to which market users may reasonably expect to have access to information differs between different markets."[1]

These researchers are internationally renowned economists and game-theorists. We would consider it appropriate to consult economists when the objective of the FSR insider trading laws is market efficiency. It would be appropriate for economists and market microstructure experts to have a greater say in the public policy formulation. We have supplied list of readings that may assist in the Appendix.

The research and evidence shows that pro-efficiency measures in markets that have retail access differ from pro-efficiency measures for non-retail access markets. For example, wholesale participants will migrate towards lower transparency markets, while retail participants will migrate towards higher transparency markets. This is a readily observable fact of the Australian financial markets.

The specific issue of OTC credit derivatives

Banks are increasingly using a variety of techniques to actively manage loan portfolios and to maximise their performance, including through the purchase or sale of physical loans and credit derivatives. APRA and international prudential regulators actively encourage management of credit portfolios by ADIs. Counterparties in this market are invariably sophisticated domestic and international institutions. Extension of the insider trading provisions to credit derivatives entered into by ADIs, as part of their portfolio management activities is not necessary either on the grounds of efficiency or public policy.

Firstly, it is anomalous that one can trade in the physical loan market with no insider trading implications, but not the credit derivative market, which simply makes the process of transacting more efficient and adds market depth.

Secondly, even if it is considered that these market participants need protection, it is submitted that such protection is afforded under the current misleading and deceptive conduct provisions, and that it is not appropriate to also bring this market within the criminal offence provisions. This argument may be applied more generally to the OTC markets as well.

[1] FSA Handbook, Chapter 1, Code of Market Conduct, Section 1.4.3, December 2001

The regulatory outcomes of the FSR insider trading laws are different from the rest of the FSR laws. (Also Part 7.10 has no regulation or policy level modification)

The Insider Trading laws are directed towards Market efficiency or market fairness. These are concepts that require economic interpretation. With the exception of some the other Part 7.10 Market Misconduct offences the remainder of the financial services reforms were directed primarily to (retail) consumer protection.

The application of new offences and penalty provisions, the changes in burden of proof and intent, while assisting with the prosecution of the offences are not necessarily germane to market fairness, and have also added further confusion to a debate which has had no resolution in over a decade.

Hidden consumer protection in the insider trading provisions – "front running"; "scalping"; "piggy backing"

The FSR Insider Trading provisions have a number of implicit consumer protection measures against "abuse of relationship" between the client and the broker or counterparty. The abuse of relationship relates to the fiduciary or stewardship responsibility that a broker has for its client, or a OTC trader where an order cannot be executed immediately due to the clients instructions (examples: Stop-loss, on-close, etc).

These abuses, while requiring regulation, should not be hidden within the provisions of the Insider Trading laws, which are apparently designed for market efficiency and fairness. They require, and should have, their own consumer protection-style laws and remedies designed accordingly.

There should be separate market misconduct provisions, applicable to OTC markets, to ensure that participants act with integrity and to provide consumer protection. The FSR Market Misconduct provisions may be the appropriate avenue for the hidden consumer protection aspects of the insider trading laws.

The concerns of the FSR Civil Penalty provisions

The best view of the new FSR civil penalties would be to encourage participants in the market participants to take direct action against each other. This is a serious concern for the Directors and officers of our Members, including the AFMA Executive Committee (the association equivalent of a Board).

Another consequence of the FSR Insider Trading provisions relating to OTC trading activity is that there are very few "actual insiders". The targets of the laws are the intermediaries – particularly those who deal in derivatives or make markets.

This consequence was recognized in the legislative changes, which passed through the houses on 21 March 2002. In his press release, the Parliamentary Secretary to the Treasurer explained the late changes to the Insider Trading Laws in the following manner:

> "They will ensure that the insider trading provisions do not jeopardise the capacity of over the counter market makers to manage risk through the use of derivative products," Senator Campbell said.

The Senators comments reflect that an unintended consequence of the FSR Insider Trading Laws was that bona fide trading by OTC participants could be considered Insider Trading. The target of the FSR Insider Trading laws is the AFS licensee, the persons who will collectively be supplying market liquidity. AFS Licensees could be viewed as "actual insiders" in areas where they are also "producers" (such as credit, mergers and takeovers advice, etc), but not in the course of their day-to-day business as intermediaries. Unfortunately, the FSR Insider trading laws makes no distinction between "actual insiders" and incidental or accidental insiders

The application of the insider trading rules to the OTC market ignores the fundamental difference between exchange traded and OTC markets. An OTC contract is a bilateral principal to principal contract executed at a negotiated price. The contract can be tailored to a client's needs in terms of product structure, settlement terms, and dealing method. Conversely, a transaction conducted on a listed exchange is subject to fixed terms and conditions that are dictated by the exchange and which indiscriminate of counterpart. Inherent in an OTC market participants ability to provide a price *is* that the participant will have information which others in the market do not have. Therefore OTC price makers may inherently be in breach of the insider trading regime when pricing OTC contracts

The case for commending the approach taken in the UK FSA Code of Market Conduct

The UK FSA Code of Market conduct applies to qualifying investments traded on a prescribed market. AFMA recommend that the Australian law should examine this approach, and prescribe what markets the Insider Trading laws apply to. The FSA Code of Market Conduct prescribes markets, for example: London Stock Exchange, AIM, LIFFE, LME, IPE. The Australia laws could prescribe markets such as the Australian Stock Exchange and Sydney Futures Exchange. Through this mechanism the law would preserve the policy basis of the pre-FSR laws, and ensure a closer analogue with international best practice.

This could be achieved in the current law by defining the term "able to be traded on a financial market". The current definition of that phrase is non-inclusive and leaves a number of questions unanswered, particularly in relation to OTC financial markets. An alternate to defining that phrase would be to replace it with "able to be traded on a licensed market", such as that used in s.1043K.

The FSA's Code of Market Conduct accepts that insider trading must relate to and reinforce the accepted disclosure regime of each unique market structure. The FSA Code also recognises that different markets differ in information that is expected by the participants in that market.

Public policy, market efficiency, and ethical regulatory environment. Can they be all optimised simultaneously?

AFMA is concerned that the application of the law is efficacious when viewed from the perspective of public policy and market efficiency. This paper includes examples that illustrate that an inappropriate doctrinaire approach is being used as the basis for "policy". A good example is the overriding doctrine of uniform regulation of functionally similar financial products. That principle is very suitable for the purposes of (retail) consumer protection for which it was designed. It enables consumers to more easily compare the advantages and disadvantages of different products. It also results in the providers of retail products being treated in a more evenhanded manner. However, this principle of uniform regulation is not

appropriate for achieving the additional objective of the financial services reforms – market integrity. Attention needs to be given to the very different nature of the markets and in particular the OTC markets. Reinforcing this point are the FSR Regulations which differentiate between transactions on a licensed exchange and those transacted over-the-counter. While it is the case that functionally similar regulation was an objective, the implementation of that objective needed to be adjusted in its application to different financial markets.

A third aspect, which is very important to AFMA, as a self-regulating association, is that of appropriate ethical balance in the laws. It is very difficult to encourage effective self-regulation in the context of laws that transparently display an attachment to a doctrinaire approach in place of an appropriate balancing of regulatory interests. For example, AFMA is of the view that it is both inefficient and unethical to devise laws that are unenforceable, or which give rise to unintended consequences, which would have been uncovered with a careful regulatory impact study.

In the case of insider trading, AFMA believes that there has been insufficient review of the so-called policy decisions made during the CLERP process. This is most clearly illustrated in the FSR Act Revised Explanatory Memorandum:

> Feedback from consultations: There were very few comments on the proposed changes to market misconduct and insider trading provisions, and no objections to the proposal to make a single set of provisions apply to all financial products that may be traded on a financial market[2][3]

While industry did not understand the scope of the Part 7.10 offence provisions until after they were passed into Law, it is clear that there are many objections to applying the Insider Trading laws to a wider range of products and a wider range of financial markets.

[2] Revised Explanatory Memorandum 2.84

[3] AFMA do not agree with the comment in the same section regarding "Costs/Benefits: Industry will benefit from the consistent regulation of functionally similar products, as they can be certain about the type of behaviour that is prohibited in relation to all relevant financial products" Explanatory Memorandum 2.82

Appendix: Some useful readings of OTC market efficiency, fairness, and transparency

Easley, D., Kiefer, N., O'Hara, M., & Paperman, J., 1995, "Liquidity, Information, and Infrequently Traded Stocks", Working Paper, Cornell University.

Bloomfield, R., & O'Hara, M. 1996, "Market Transparency: Who wins and who loses?", Working Paper, Johnson Graduate School of Management, Cornell University.

Bloomfield, R., & O'Hara, M. 1997, "Can Transparent Markets Survive?", Working Paper, Johnson Graduate School of Management, Cornell University.

Brown-Hruska, S. & Laux, P., 1997, *The Role of EFPs in Futures Markets - An old dog does new tricks"*, Research Paper, Catalyst Institute.

IOSCO Technical Committee Working Party on the Regulation of Secondary Markets, 1992, *Transparency on Secondary Markets - a synthesis of the IOSCO debate*, International Organization of Securities Commissions, Milano, Italy.

Lamourex, C., & Schnitzlein, C., 1997, "When its not the only game in town: The effect of bilateral search on the quality of a dealer market", *Journal of Finance*, 683-712.

Lyons, R., 1996, "Optimal transparency in a dealership market with an application to foreign exchange", *Journal of Financial Intermediation*, 5.225-254.

Madavan, A., 1996, "Security Prices and Market Transparency", *Journal of Financial Intermediation*, 5.255-283.

O'Hara, M., 1995, *Market Microstructure Theory*, Blackwell Publishers, Cambridge, MA.

Appendix: EXAMPLES OF COMMON TRADES, WHICH WILL BE IMPACTED BY INSIDER TRADING LEGISLATION

A member bank sought independent legal opinion on four common or everyday OTC transactions (It was also assumed that all trades in the scenarios provided may "materially" move the market). Based on the Act, Regulations and amendments/updates as at the end of March the **draft legal advice** received is that only in one scenario is the situation clear cut as to whether the bank has breached the insider trading provisions.

Scenario 1 – Clarified as not in breach

Client A telephones Bank X for a firm quote on a seven year Australian dollar interest rate swap in A$250m which the client accepts. Bank X then commences hedging the swap in the markets using a mixture of swaps, physical bonds and bond futures.

Before Bank X has completed hedging Client B calls and asks for a firm quote on A$150m. The price quoted to Client B reflects the risk held by the Bank from the previous transaction.

The view is Bank X would be exempt from the insider trading provisions under regulation 9.12.03 (íts "own intentions"). Further, the amendments to the Act would also exempt Bank X under s1043I(1) and (2).

Scenario 2 – Unable to clarify based on current law

Client A telephones Bank X seeking a firm quote on a seven year Australian dollar interest rate swap in A$250m. The client indicates that they are seeking quotes from three banks and want the quote-held firm for 2 minutes.

The dealer at Bank X is aware that the relationship manager is keen for the bank to win the business. The dealer quotes competitively but this can only be done on the basis of him pre hedging part of the risk even though he may be out bid on the quote. (If the quote is unsuccessful there is no guarantee that the dealer will be able to unwind the hedge profitably.)

The view is that in this scenario Bank X has a piece of information which is exempted by the regulations, i.e. it proposes to enter a transaction with the client. However, there is another piece of information regarding the client's intention to enter into a transaction. The Bank therefore has knowledge of the client's trading intentions as well as its own, and those intentions may not involve the Bank.

Based on amendments to the Act, Bank X will be exempt under s1043I(1) and (2) in relation to the information that it proposes to enter a transaction with the client. The issue with regard to the information of the client's intention is still present.

Scenario 3– Unable to clarify based on current law

Client A telephones Bank X seeking an indicative quote on a seven year Australian dollar interest rate swap in A$250m. The dealer at Bank X concludes that the client will deal today, if not with Bank X then with another Bank and buys bond futures to reduce his current risk position which will lose money if the trade goes ahead and materially impacts the market.

Scenario 4– Unable to clarify based on current law

As for scenario 3 but dealer has no open position when taking the call but buys bonds to benefit if the trade should proceed and materially move the market.

For both scenarios 3 and 4 the relevant information is what Client A might do (i.e. there is a possibility of activity). If this knowledge is sufficient to move the market and the approaches to banks by Client A have not been sufficient to make it generally available information, then there may be a breach of the insider trading provisions in the absence of any other defence.

The following are "real" examples where the FSR laws have unintended consequences by outlawing regular OTC financial market activity which would be considered regular activity by OTC financial market participants. The AFMA FSR Task Force with ABA and IBSA has collated these examples.

Example – "producers" risk management - Electricity Hedging

The only risk management transaction available for retailers or generators of electricity is to enter into bilateral electricity "swap" contracts. A derivative under FSR.

It is arguable that one or both could have inside information, that would not be able to be managed using a Chinese Wall. Generators may have some information about generation capacity and their bidding in the National Electricity Market. Retailers may have information about load, curtailability of load and demand side management. This is illustrated by a certain asymmetry that is mandated by the NEC which requires generators to publicly pre-notify generation capacity to NEMMCO, where there is no obligation on retailers as regards the demand side, load curtailability etc.

Example – Portfolio Management

Banks with a loan portfolio seek to maximise the performance of the portfolio by actively managing it, by buying and selling a variety of instruments, including physical loans, fixed interest securities, options and credit derivatives.

The decision to buy or sell a corporate credit could be driven by a variety of factors, including:

- a desire to free up credit limits to allow more business
- the view of a sector or country
- perceived credit issues, which could be based either on public or non-public information
- a desire to balance a portfolio between geographic regions and economic sectors
- capital attribution issues associated with internal or external credit ratings (ie more capital is required to support a loan with a lower credit)
- large credit exposure policies or other policy considerations.

The area responsible for the decision to buy or sell a credit would not usually be aware of any inside information relating to the credit in question. However, a transaction decision could be tainted by inside information which is contained in other parts of the organisation in circumstances where there was no intention to profit from that information.

Putting the portfolio management area behind a chinese wall would not protect the process because transaction decisions need to take into account internal risk ratings and other credit requirements which are set by credit areas who must by definition be on the client side of the chinese wall. So even if a credit decision or rating is based on non-price sensitive factors (eg economic/sector/large credit exposure policies, etc) if at that time the credit area has inside information, then it could be said that the Bank is at risk of committing insider trading (under section 1043A(1)(d)) if any aspect of the credit process can be said to have influenced the transaction decision (which will often be the case), even where that decision was made by a person behind a chinese wall.

This inhibits the bank from carrying out bona fide risk management and portfolio management activities that are strongly supported by prudential regulators. It also creates an anomaly in that the same exposures could theoretically be obtained in the physical market with no insider trading concerns, subject to the additional inefficiencies that this would create (note however that transaction cost and the lack of liquidity in the physical market militates against this).

Example - effect of S. 1042G

The CEO of an existing major client calls on the MD of a bank. The CEO informs the MD that his company is experiencing trading difficulties and asks for some modification of its credit terms. Assuming this met the definition of insider information under S.1042A, then it would also mean that the bank would be taken to possess this information under S. 1042G. (It should be noted in passing that the bank has no mechanism for publicly disclosing this information, nor indeed may it do so without breaching client confidentiality. If information is market sensitive, it is the client's responsibility to disclose - not its bankers).

Six floors below and quite incidentally (ie. without knowledge of the MD's meeting with the client nor of its content) and as part of his normal trading activities a trader buys credit protection on the client from counterparty A (another bank). Six months later, the client suffers a rating downgrade, thereby increasing the value of the protection significantly. A sues for damages on the basis that the bank has traded on insider information.

The bank's only defence would be to rely on S1043F ("Chinese Wall arrangements by bodies corporate"). Thus it would have to demonstrate to the satisfaction of the court that Chinese Wall "arrangements" existed between the MD and the Trader and also between any intervening person between the MD and the Trader. Presumably, these arrangements would need to be substantive, identifiable and auditable to satisfy the provisions of 1043F. This effectively means that contact between the MD and the Trader, and anyone else either of them would come into contact with inside the organisation, has to be carefully circumscribed.

The position is even more fraught with difficulty because a bank is awash with credit information – the reason being that providing credit is its core business. Furthermore, that information may emerge in, or pass to, various departments of the bank such as Tax, Finance, Legal, Credit Assessment and a host of others as well as the normal line banking centres. In this context the footnote #265 to Paragraph 2.192 of the Discussion Paper is germane to this issue, except that in the footnote's example the trader procures a client to trade, whereas in the circumstances described above it is the bank itself that is trading. The conclusion is that the law forces the bank to institute a multitude of Chinese Walls within the organisation, making the monitoring of compliance a nightmare undertaking - a clearly impractical outcome.

A solution is to exempt credit providers from the provisions of S.1042G whereby insider information relating to the credit worthiness of an existing client is imputed to the organisation as a whole merely because one of its officers receives that information in the course of his duties.

This example and the proposed solution does not preclude a wider exclusion of derivatives from the insider trading provisions of the FSRA. Arguments for that outcome are included elsewhere in this submission.

Example – orders that cannot be executed immediately:

Large client orders not "at market", that is, at the prevailing price. Examples include stop-loss, good 'til done at a price, "take profit", etc. These are the so-called "book" orders.

May be inside information and material, but what if the "orders" are not at the current price. That is they may or may not be material in the future, but that would have to be assessed contextually. Therefore can the Bank deal now with knowledge of the client's future trading intentions, even though they are probably going to deal with the Bank?

Example – Credit event of a client trading

LargeMiningCo had entered into a series of FX and silver derivatives with approximately 30 different banks. These banks constituted all the market makers for FX and silver in Australia. LargeMiningCo then experienced financial difficulties – the 30 banks involved were all aware of this. This information was price sensitive with respect to Australian FX and silver prices. Consequently, the banks involved had insider-trading information, but not as a direct result of their trading or market making activities.

The FSR own transaction exemption would not have been available in this example. The Chinese walls exemption would also not given relief as each of the Banks needed to draw on the expertise of different parts of their organisations, and would have breached a Chinese wall. It may also be an issue where there is only a single dealer able to trade a particular product (say, silver).

If this had occurred under the FSR regime, all 30 banks would have been barred from participating in the Australian FX and silver markets while they had this information. There may have been a serious reduction in the efficiency of the Australian FX or silver markets while the situation continued.

Whilst it may be possible to argue that this is an rare incident, the same principle applies whenever a syndicate of banks is involved with a large corporation, and the corporation puts the syndicated banks on notice that it is going to do something which would affect an OTC market. This includes informing the syndicate banks that the corporation has plans to move offshore, has takeover plans or is in financial distress.

(Note: many firms would not allow the knowledge of financial difficulties to reach the traders. That information would be behind the Chinese Wall with Credit and senior mgmt as necessary to assess our exposures. If necessary due to expertise we would bring a trader over the wall but in the knowledge that they could not trade. Also it is sometimes possible to obtain the necessary expertise from a person without giving them the specific circumstances etc.)

Appendix: Members of AFMA as at April 2002

FULL MEMBERS

ABN Amro Bank N.V
Adelaide Bank Limited
AMP Henderson Global Investors
AMP Services Limited
Arab Bank Australia Limited
Australia and New Zealand Banking Group Limited
AWB Limited
AXA Australia
BA Australia Limited
Bank of China
Bank of Queensland
Bank of Tokyo-Mitsubishi Australia Ltd
Bank of Western Australia Limited
Bank One, NA
Barclays Bank PLC
Bendigo Bank Limited
BNP Paribas
BOS International (Australia) Limited
Citigroup
Commonwealth Bank of Australia
Country Energy
Credit Agricole Indosuez Australia Ltd
Credit Suisse First Boston Limited
Credit Union Services Corporation (Australia) Limited
CS Energy Ltd
Delta Electricity
Deutsche Bank AG
Dresdner Bank AG, Australian Branch
Duke Energy Australia Trading & Marketing Pty Ltd
EdgeCap Pty Ltd
Energex Retail Pty Ltd
Eraring Energy
Ergon Energy Pty Ltd
Energy Australia
Enertrade
Enron Australia Finance Pty Ltd
Goldman Sachs Australia Pty Limited
HSBC Bank Australia Limited
Hydro-Electric Corporation
ICAP Australia Pty Ltd
ING Bank (Australia) Limited
ING Bank NV Sydney Branch
InterGen (Australia) Pty Ltd
Integral Energy Australia Corporation
J B Were Capital Markets
JPMorgan Chase Bank
Loy Yang Power Management Pty Ltd
Macquarie Bank Limited
Macquarie Generation
Merrill Lynch (Australia) Pty Ltd
Mizuho Corporate Bank Ltd, Sydney Branch
N M Rothschild & Sons (Australia) Limited
National Australia Bank Limited
National Power Australia Pty Ltd
Nomura Australia Limited
Northern Territory Treasury Corporation
NRG Flinders
NSW Treasury Corporation
OCBC Bank
Origin Energy
Prebon Yamane Money Markets (Australia) P/L
Primary Industry Bank of Aust. Ltd
Queensland Investment Corporation
Queensland Treasury Corporation
RBS (Australia) Pty Ltd
Royal Bank of Canada
SG Australia Limited
Snowy Hydro Trading Pty Ltd
South Australian Government Financing Authority
Southern Hydro Partnership
St. George Bank Limited
Stanwell Corporation Limited
Sumitomo Mitsui Finance Australia Limited
SUNCORP-METWAY Ltd
Tarong Energy Corporation Limited
Tasmanian Public Finance Corporation
Telstra Corporation Limited t/as Telecom Australia Limited
TFS Australia Pty Ltd
The Australian Gas Light Company
The Toronto Dominion Bank Australian Branch
Treasury Corporation of Victoria
Tullett & Tokyo Liberty Pty Ltd
TXU Trading
UBS Warburg Australia Limited
UFJ Australia Limited
United Overseas Bank Limited
Western Australian Treasury Corp.
WestLB Sydney Branch
Westpac Banking Corporation
Yallourn Energy Pty Ltd
Zurich Capital Markets Australia Ltd

ASSOCIATE MEMBERS

Chimaera Consulting Pty Ltd
Coles Myer Finance Limited
CSR Limited
Edison Mission Energy Australia Pty Ltd
Hazelwood Power
Rio Tinto Limited
SFE Corporation Limited
TEHQ Australia Energy Trading Pty Ltd
TIO Finance

AFMA PARTNER MEMBERS

Allens Arthur Robinson
Baker & McKenzie
Clayton Utz
Corrs Chambers Westgarth
Freehills
Henry Davis York
Mallesons Stephen Jaques
Minter Ellison
OM Technology Pty Ltd
Optus Communications
Syntegra (Australia) Pty Ltd

AFFILIATE MEMBERS

Australian Taxation Office (NSW)
Australian Prudential Regulation Authority (APRA)
Australian Securities & Investment Commission (ASIC)
Commonwealth Treasury
International Swaps & Derivatives Association (ISDA)
International Securities Market Association (ISMA)
National Electricity Market Management Company Ltd (NEMMCO)
Reserve Bank of Australia

Appendix: Members of the AFMA FSR Task Force

First Name	Last Name	Organisation
Michael	Cleland	Australia and New Zealand Banking Group Limited (VIC)
Bill	Fuggle	Baker & McKenzie
Helen	Bakoulis	Citigroup (NSW)
Victoria	Weekes	Citigroup (NSW)
Debra	Cass	Commonwealth Bank of Australia
Peter	Green	Commonwealth Bank of Australia, Sydney
Andrew	Lumsden	Corrs Chambers Westgarth
Anastasia	Economou	Credit Suisse First Boston Australia Limited, NSW
Charmaine	Byrne	Credit Suisse First Boston Australia Limited, NSW
Andrew	Robertson	Deutsche Bank AG (NSW)
Scott	Carran	JPMorgan
Camille	Blackburn	Macquarie Bank Limited
Julie	Abramson	National Australia Bank Limited (Vic)
Terence	Keefe	National Australia Bank Limited (Vic)
Scott	Mannix	NSW Treasury Corporation
Doug	Clark	Securities & Derivatives Industry Association
Sean	Rahilly	SG Australia Limited
Astrid	Gates	St George Bank Limited
James	Andrae	Tarong Energy Corporation Limited
Euan	Macallan	Treasury Corporation of Victoria
Tracy	Hudson	Westpac Banking Corporation
David	Pearson	Westpac Banking Corporation, Sydney
Orla	Fisk	Zurich Capital Markets Australia Ltd
John	Rappell	Australian Financial Markets Association
Alexandra	Johnson	Australian Financial Markets Association

Appendix: OTC vs exchange traded turnover data: Australian Financial Markets Report

1.1: The Australian Financial Markets - Summary of Total Market Turnover						
	Annual Turnover (AUD billion)a					
	1996-97	**1997-98**	**1998-99**	**1999-00**	**2000-01**	**% Changeb**
OTC Financial Markets						
Government Debt Securities	1,387	1,102	1,054	1,043	1,019	(2.3)
Non-Government Debt Securities	62	82	150	205	257	25.2
Negotiable & Transferable Instruments	1,334	1,599	1,872	2,063	2,448	18.7
Repurchase Agreements	2,413	3,117	3,918	5,498	5,017	(8.8)
Swapsc	410	451	577	868	1,470	69.4
Forward Rate Agreements	518	498	527	1,060	1,675	58.1
Interest Rate Options	71	66	53	51	52	1.7
OTC Equity Derivatives			8	11	15	37.3
Credit Derivatives				18	28	53.3
Foreign Exchange	15,320	17,249	19,131	15,942	18,181	14.0
Currency Options	334	569	655	606	909	50.1
Total OTC Financial Markets	**21,849**	**24,763**	**27,945**	**27,365**	**31,071**	**13.5**
Exchange Traded Markets						
Equities						
ASX Shares	211	243	282	362	418	15.4
ASX Options	98	74	91	104	133	27.7
Total Equities Markets	309	317	373	466	551	18.1
Futures						
SFE Futures	7,396	8,703	9,428	9,753	10,709	9.8
SFE Options	1,316	964	752	556	450	(19.1)
Total Futures Markets	8,712	9,668	10,180	10,309	11,159	8.2
Total Exchange Traded Markets	**9,021**	**9,985**	**10,553**	**10,775**	**11,709**	**8.7**
All Financial Markets	**30,870**	**34,718**	**38,498**	**38,140**	**42,781**	**12.2**
OTC Electricity Derivatives				133	203	52.7
				million megawatt hours		

1.2: The Australian Financial Markets - Summary of Total Market Turnover						
	Annual Turnover (AUD billion)					
	1996-97	1997-98	1998-99	1999-00	2000-01	% Change
Debt Markets						
Physical Market Turnover						
Government Debt Securities	1,387	1,102	1,054	1,043	1,019	(2.3)
Non-Government Debt Securities	62	82	150	205	257	25.4
Negotiable & Transferable Instruments	1,334	1,599	1,872	2,063	2,448	18.6
Sub-Total	2,783	2,783	3,076	3,311	3,724	12.5
Off Balance Sheet Turnover						
Repurchase Agreements	2,413	3,117	3,918	5,498	5,017	(8.8)
Swaps	410	451	577	868	1,470	69.3
Forward Rate Agreements	518	498	527	1,060	1,675	58.1
Interest Rate Options	71	66	53	51	52	1.9
Credit Derivatives				18	28	49.7
SFE Interest Rate Futures and Options	8,483	9,388	9,839	9,884	10,810	9.4
Sub-Total	11,895	13,520	14,914	17,379	19,052	9.6
Total Debt Markets	**14,678**	**16,303**	**17,990**	**20,690**	**22,776**	**10.1**
Multiple of Off-Balance Sheet Activity						
to Physical	4.3	4.9	4.8	5.2	5.12	
Currency Markets						
Physical Market Turnover						
Spot Foreign Exchange	5,887	7,156	8,312	5,805	5,315	-8.4
Sub-Total	5,887	7,156	8,312	5,805	5,315	-8.4
Off Balance Sheet Turnover						
FX Swaps	8,811	9,173	9,688	9,165	11,602	26.6
Forward Foreign Exchange	622	920	1,131	972	1,264	30.0
Currency Options	334	569	655	606	909	50.1
Sub-Total	9,767	10,692	11,474	10,743	13,775	28.2
Total Currency Market	**15,654**	**17,818**	**19,786**	**16,548**	**19,090**	**15.4**
Multiple of Off-Balance Sheet Activity						
to Physical	1.7	1.5	1.4	1.9	2.6	
Equities Market						
Physical Market Turnover						
ASX Shares	211	243	282	362	418	15.5
Sub-Total	211	243	282	362	418	15.5
Off Balance Sheet Turnover						
ASX Options	98	74	91	104	133	27.7
OTC Equity Derivatives			8	11	15	43.0
SFE Equity Futures and Options	229	280	341	425	349	(17.9)
Sub-Total	327	354	440	540	497	(7.9)
Total Equities Market	**538**	**597**	**722**	**902**	**915**	**1.4**
Multiple of Off-Balance Sheet Activity						
to Physical	1.5	1.5	1.6	1.5	1.2	
All Financial Markets	**30,870**	**34,718**	**38,498**	**38,140**	**42,781**	**12.2**
OTC Electricity Derivatives				133	203	52.8
				million megawatt hours		

Appendix: Responses to selected Issues raised by CAMAC

CHAPTER 1

1.11 (p. 13) Identifying the reasons for prohibiting insider trading is fundamental to the appropriate development and application of insider trading laws. Is the jurisprudential basis for the current Australian legislation satisfactory?

No Comment

Issue 1. (p. 19) Are the current market fairness and market efficiency rationales for the Australian insider trading legislation appropriate?

Yes. AFMA would consider that these two rationales are appropriate and would lead to three considerations:
1. that insider trading would be limited to financial products that are traded on a licensed market, or capable of being traded on a licensed market. The rationales of market integrity and efficiency based on licensed markets are unhelpful to OTC financial market trading.
2. that fairness and efficiency are further defined or their dimensions understood
3. that the balance between civil, criminal, and statutory remedies reflects these rationale(s)

1.36 (p. 19) Should insider trading laws cover only non-public price-sensitive information derived from within the entity whose securities are traded (the narrow approach) or any non-public price-sensitive information affecting particular securities that is not available to the market, regardless of its source (the broad approach)?

The narrow approach is more appealing from the view of enforcement and also the rationale established above. While the Broad approach may be appealing on paper it has two critiques:

1. is more difficult to see the causality of broad information to the rationale(s); and,

2. it is far more difficult to confine the manner of information. For example, a rate-cut by the RBA will affect all tradeable financial products.

1.37 (p. 19) Also, should the definition of inside information be confined to information that relates to a company or its securities, while excluding information that relates only to securities generally or to issuers of securities generally?

Our response is similar to that above for section 1.36 of the discussion paper. We would recommend that the information is confined to that relating directly to the specific company or security, and not to companies or securities generally.

There is a further issue on the subject of issuers – particularly in the new FSR regime, where some dealers are deemed issuers – particularly in derivatives transactions. Examples: the advising stockbroker is a deemed issuer for the purpose of exchange traded derivatives, the OTC AFS licensee is the deemed issuer for the purposes of any OTC derivative including the vast majority of foreign exchange. Accordingly, the scope of the term issuer requires

closer attention and definition to ensure that "deemed" issuers are not confused with initial issuers or persons regulated under Chapter 6. This approach has been adopted for ASX warrant issuance and trading.

Two aspects of issuance that require further investigation relate to the scope of products where an entity is the issuer, but not subject to the provisions of the Corporations Law – government bonds are an example. There is a possibility of a non-level playing field or breach of the principals of competitive neutrality. Related is the scope of the FSR products definitions where government bonds include bonds "proposed to be issued". FSR s.764A1(j).

Issue 2. (p. 21) Is the current Australian broad approach to the definition of inside information appropriate? Should the legislation exclude information that relates only to securities generally or to issuers of securities generally?

See above.

Issue 12. (p. 55) Should the range of financial products covered by the insider trading provisions of the Financial Services Reform Bill exclude indices, derivatives over commodities and/or any other financial products?

The insider trading laws should exclude all transactions and products traded exclusively in the OTC financial markets. Insider trading laws should apply to products which are is capable of being traded on a public or licensed market.

The FSR definition of "able to be traded on a financial market" is insufficiently prescriptive and creates uncertainty – particular when applied to non-licensed markets.

2.93 (p. 55) Should the insider trading legislation be limited to financial products that are traded or tradeable on a public market?

Issue 13. (p. 57) Should the insider trading legislation apply to any trading or only transactions that are or can be carried out on a public market?

The Australian Financial Markets Association strongly agrees with a proposal that insider trading legislation be limited to transactions and products that are or can be carried out on a public market. AFMA believe that the insider trading laws are part of a regulated disclosure regime. The OTC markets do not have the requirement, or the mechanism, or the participant expectation for public (or even participant) disclosure. Further, our submission indicates that the application of insider trading laws to non-public markets is untried and will have unintended consequences. Those consequences could include a reduction in liquidity, participation, and overall efficiency of an OTC market. We would content that this is the reverse of what is intended with insider trading laws.