

COMPANIES AND SECURITIES
ADVISORY COMMITTEE

**Law of Derivatives:
An International Comparison**

JANUARY 1995

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The Companies and Securities Advisory Committee

Role

The Companies and Securities Advisory Committee (the Advisory Committee) was established under Part 9 of the Australian Securities Commission Act 1989 (the ASC Act). Its functions are set out under s 148 of that Act, namely:

"on its own initiative or when requested by the Minister, to advise the Minister, and to make to the Minister such recommendations as it thinks fit, about any matter connected with:

- . a proposal to make a national scheme law, or to make amendments of a national scheme law;
- . the operation or administration of a national scheme law;
- . law reform in relation to a national scheme law;
- . companies, securities or the futures industry; or
- . a proposal for improving the efficiency of the securities markets or futures markets".

Membership

The Advisory Committee comprises part-time members selected from throughout Australia on the basis of their knowledge or experience in business, the administration of companies, the financial markets, law, economics or accounting. Members, other than the ASC Chairman, who is a member pursuant to s 147 of the ASC Act, are appointed to the Committee in their personal capacity by the Federal Attorney-General. The members are:

David Hoare (Convenor), Chairman - Bankers Trust Australia, Sydney

John Barner, Director Finance and Administration - Coles Myer Ltd, Melbourne

Reg Barrett, General Counsel - Westpac Banking Corporation, Sydney

Philip Brown, Professor of Accounting - University of Western Australia, Perth

Alan Cameron, Chairman - Australian Securities Commission

David Crawford, Chairman - KPMG Peat Marwick, Melbourne

Kevin Driscoll CBE, Chairman - National Homes Pty Ltd, Brisbane

Patricia Faulkner, Director, Financial & General Management - KPMG Peat
Marwick, Melbourne

Leigh Hall, Deputy Managing Director - AMP Investments Australia Ltd,
Sydney

Patricia Khor, Consultant - McKinley Wilson Ltd, Melbourne

Wayne Lonergan, Partner - Coopers & Lybrand, Sydney

Ann McCallum, Audit Partner - Garraway & Partners, Darwin

Alan McGregor AO, Chairman - FH Faulding & Co Ltd, Adelaide

Mark Rayner, Group Executive - CRA Ltd, Melbourne

John Story, Managing Partner - Corrs Chambers Westgarth, Brisbane.

Secretariat

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Officers

Vincent Jewell

Stephen Lyons

Paula George (to 7 October 1994)

Executive Assistant

Thaumani Parrino

This Paper was prepared by the Secretariat.

Abbreviations

ALRC	Australian Law Reform Commission
AOM	Australian Options Market
ASC	Australian Securities Commission
ASX	Australian Stock Exchange
CAF	Client Agreement Form
CFTC	Commodity Futures Trading Commission
CHES	Clearing House Electronic Subregister System
CIPF	Canadian Investors Protection Fund
CTA	Commodity Trading Advisor
EETO	Eligible exchange traded option
FAST	Flexible Accelerated Security Transfer
FCM	Futures commission merchant
FDIC	Federal Deposit Insurance Corporation
FDICIA	Federal Deposit Insurance Corporation Improvement Act
FIRREA	Financial Institutions Reform, Recovery and Enforcement Act
JRFQR	Joint Regulatory Financial Questionnaire and Report
OCC	Options Clearing Corporation
OSC	Ontario Securities Commission
OSFI	Office of the Superintendent of Financial Institutions
OTC	Over the counter (ie, non-exchange-traded)
RORO	Recognized Options Rationalization Order
SEC	Securities and Exchange Commission
SFA	Securities and Futures Authority
SFE	Sydney Futures Exchange
SIB	Securities and Investments Board
SPI	Share price index
SRO	Self-regulatory organisation
TFE	Toronto Futures Exchange
TSE	Toronto Stock Exchange

Introduction

The Advisory Committee is currently reviewing the law and practice relating to exchange-traded and off-market (OTC) derivatives. This review has been prompted by the rapid growth in volume and complexity of the Australian derivatives market and comparable overseas markets. The Advisory Committee's task is to ensure appropriate protection for participants in Australia while encouraging the benefits of a free, innovative and internationally competitive Australian derivatives market.

This Paper is the first step in the Committee's review. It

- identifies which derivatives are regulated by the Corporations Law
- outlines the key features of how the Corporations Law applies to regulated derivatives*
- examines how derivatives are regulated in the United Kingdom, Canada and the United States and outlines some reform proposals in those jurisdictions.

The Advisory Committee considers that an international comparison is essential. Derivatives are traded globally and any change to Australian law needs to take proper account of overseas regulation. This will help to ensure that any changes do not unnecessarily place the Australian market at a competitive disadvantage.

The Advisory Committee plans to issue a Discussion Paper later in 1995 outlining specific issues and proposals for reform. In developing its proposals, the Committee will have close regard to the law and developments in overseas jurisdictions.

* This paper does not deal with accounting, taxation or prudential issues involving derivatives. It excludes, for instance, Part 7.5 and Part 8.5 (accounts and audit) of the Corporations Law and related accounting provisions. Netting of derivative transactions in Australia will be dealt with in a separate Advisory Committee Report.

CHAPTER 1. OVERVIEW OF DERIVATIVES

"Futures and commodity options trading is among humanity's more impenetrable concepts. It involves selling what one does not own and, as a rule, buying what one does not want. It is deeply shrouded in terminology that conceals its meaning. It operates in an arena where opinion is everything, where supply and demand are hard to distinguish from supposition and doctrine, and where inherent uncertainty has spawned an endless holy war between two religious-sounding antagonists, the "fundamentalists" and the "chartists", not to mention the new breed of computer-dependent faithful. Into this world comes the general public, eager to enjoy its riches and often unprepared to become its poor."¹

Definition

A derivative is a financial instrument whose value is derived from some other thing, such as:

- . a physical commodity (for instance, wool, cattle, oil, or gold)
- . a financial asset (for instance, shares or bonds)
- . an index (for instance, a share price index)
- . an interest rate
- . a currency
- . another derivative.

Characteristics of derivatives

All derivatives are based on one or both of two primary elements:

- . *the forward contract*, which is an agreement between two parties to take the opposite side of a transaction having particular agreed terms² on a future date
- . *the option contract*, which obliges the grantor to enter into a transaction having particular agreed terms on a future date,

¹ PM Johnson & TL Hazen *Commodities Regulation* (2nd ed, Little Brown and Company, 1989) Vol III at 155.

² For instance, one agrees to buy and the other to sell a particular commodity at a set price, or one to borrow and the other to lend at a fixed interest rate.

generally in return for a premium, and gives the taker a right, not an obligation, to take the opposite side of the transaction.³

Derivatives last for a fixed period. Unlike equities, they do not generally provide an ongoing participation in an enterprise.⁴ Parties to a derivative may be obliged to make margin payments during the currency of the derivative to reflect market changes in the derivative's value. Derivatives may be settled by delivery of the thing on which they are based. More commonly, the parties' obligations are settled in cash at expiry, even those arising from derivatives based on physical commodities. The settlement amount is generally small compared with the value of the underlying subject matter.⁵

Some derivatives may only be traded on-exchange, while others may be traded off-exchange. Those traded on-exchange have standardised terms setting out, for instance, the quantity and type of underlying commodity or financial instrument. Their settlement is guaranteed by a clearing house. Derivatives not traded through organised exchanges are described as over the counter derivatives (OTC derivatives). The terms of OTC derivatives are individually negotiated by the parties to suit their particular circumstances. Examples include swaps and forward rate agreements. OTC transactions are not cleared through a clearing house. The existence and content of any margining requirements depend on the terms of the individual OTC derivative.

Use of derivatives

Derivatives can be used to isolate and manage the risks in traditional financial instruments. They may be used to offset the risk of a change in the value of something that affects a person's ability to make a profit, for instance:

³ N Cavalla, *OTC Markets in Derivative Instruments* (Macmillan, 1993) at 1; GL Gastineau, *Dictionary of Financial Risk Management* (Swiss Bank Corporation, 1992) at 113; Group of Thirty Global Derivatives Study Group, *Derivatives: Practices and Principles* (Group of Thirty, 1993) at 28-34. For a discussion of whether forwards include options see M Hains, "Futures Contracts: Do They Include Forwards and Swaps?", in G Walker & B Fisse (eds), *Securities Regulation in Australia and New Zealand* (Oxford University Press, 1994) 846.

⁴ However, options over shares will provide an ongoing participation in a company if exercised.

⁵ For instance, the settlement amount of an interest rate derivative will be the difference between the interest payable at the market or other variable rate and the interest that would be payable at the rate fixed by the derivative.

- by a purchaser or seller of physical commodities to offset possible adverse price changes
- to offset changes in interest rates and currency exchange rates.

Derivatives may also be used by persons not having a direct interest in the subject matter of the derivative. The presence of these persons adds depth to derivatives markets.⁶

Participants in derivatives markets

Those involved in derivatives markets are often referred to as "end-users" and "intermediaries" (or "dealers").

End-users use derivatives to manage financial risks arising in the course of their business. Typical end-users are financial institutions, government bodies and institutional investors.

Intermediaries may act either as brokers in matching two participants to a deal or more commonly as counterparties or principals to meet a customer's requirements. Intermediaries manage the risks assumed as principal either by entering into specific offsetting transactions or by assessing the transactions against their existing portfolio.

Intermediaries may also engage in derivatives transactions for their own purposes to utilise arbitrage opportunities or to take market risk positions. An entity may participate in derivatives activity both as an end-user and as an intermediary. The main intermediaries are banks and securities firms.

Comparison of derivatives regulation

This Paper examines the scope and content of derivatives regulation in Australia, the United Kingdom, Canada⁷ and the United States. Some of the key points of comparison are summarised.

⁶ They "absorb the risk that others do not want and provide a means of adding returns to uncorrelated portfolios and investments": DM Fitzgerald & C Lubochinsky, *Financial Futures* (Euromoney Publications, 1993) at 306.

⁷ The review of Canadian law concentrates on Ontario and refers, where appropriate, to national developments.

Basis of regulation. The UK regulates both on-exchange and OTC derivatives (options, futures, contracts for differences) under a broad definition of

"investment". It regulates according to the type of participant in the investment transaction. Australia, Canada and the US regulate primarily according to a legislative division between futures and securities derivatives, not the type of participant.⁸

Exchange-trading requirement. In Australia, futures contracts, but not other derivatives, must generally be traded only on-exchange. In the UK, derivatives may be traded either on-exchange or OTC, apart from certain transactions involving the least sophisticated type of customer, which must be on-exchange. In Canada, only commodity futures contracts, commodity futures options and certain recognised options must be exchange-traded. In the US, derivatives must be traded on-exchange, except for swaps, forward contracts, products based on swaps and forwards and securities options. These may be traded OTC.

In the UK, on-exchange dealings between sophisticated participants are in many cases subject to a lesser level of regulation. This approach has not been adopted in Australia, Canada or the US.

SROs. In the UK, derivatives regulation is primarily the responsibility of SROs. All other jurisdictions divide regulatory responsibility between government agencies and SROs.

Licensing. In all jurisdictions other than the UK, the granting and revocation of licences is primarily the responsibility of the regulatory agency. SROs perform these functions in the UK.

Risk disclosure. All overseas jurisdictions have risk disclosure requirements for on-exchange derivative transactions. Australia has risk disclosure requirements for futures contracts and some securities. Australia, Canada and the US apply risk disclosure requirements to all participants whereas the UK requirements only apply to the least sophisticated clients.

Australia and, in general, the US have no risk disclosure obligations for off-exchange dealings. The UK imposes these obligations for off-exchange

⁸ There are exceptions. For instance, ASC Policy Statement 70 (Exempt Futures Markets) focuses on both the sophistication of the participant and the type of transaction, as do the CFTC swaps exemption and the proposed Ontario Securities Commission Policy Statement on over the counter transactions.

dealings with the least sophisticated clients. A similar rule is proposed for Canada.

Suitability requirements. The UK and Canada have a "know your client" rule which includes a positive obligation to seek information from a client. In the UK, this rule only applies to transactions for the least sophisticated clients. Australia and the US have suitability requirements for securities, but not futures, derivatives.

CHAPTER 2. AUSTRALIA

Outline

The Corporations Law does not use the term "derivative". To ascertain if and how a derivative is regulated, it is necessary to determine whether it is:

- a futures contract regulated under Chapter 8 of the Corporations Law or, if not
- a security regulated under Chapter 7 of the Corporations Law.

A derivative that is not a futures contract or a security is not regulated under the Corporations Law.

This Chapter first examines the definitions of "futures contract" and "securities". It next discusses the following definitional issues:

- the appropriateness of a standardisation or fungibility criterion in the futures contract definition
- the problems with the statutory exclusions from the definition of futures contract
- the difficulty of classifying various types of options and the possibility of designing them to avoid regulation as either futures contracts or securities
- uncertainties resulting from the statutory mechanism for distinguishing futures contracts from securities.

The Chapter then sets out key differences in the content of regulation of "futures contracts" and "securities".

Scope of regulation

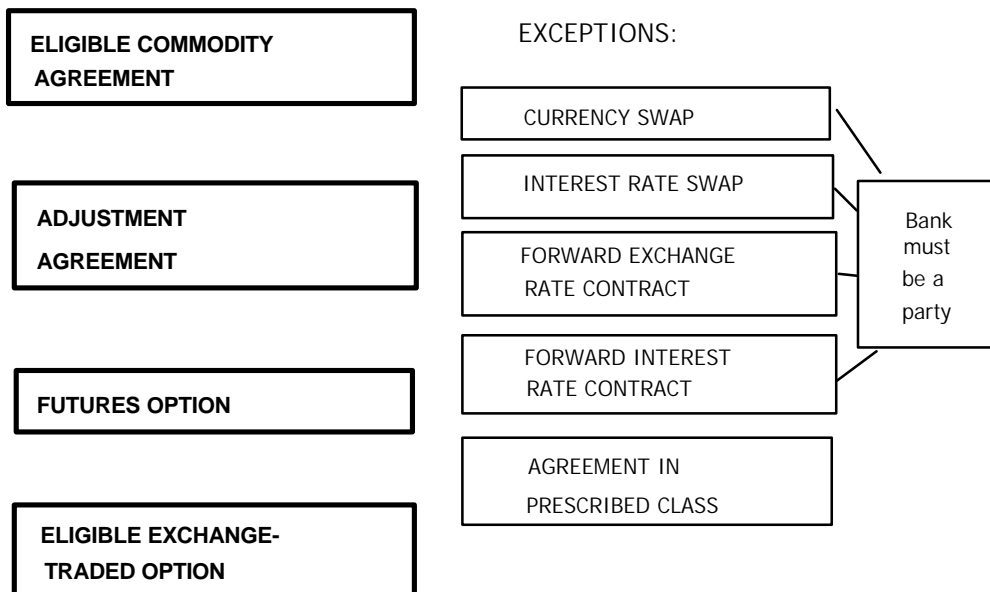
Definition of "futures contract"

Section 72 exhaustively defines "futures contract". It describes four distinct kinds of "futures contract", each of which is defined in s 9:

- . an eligible commodity agreement
- . an adjustment agreement
- . a futures option
- . an eligible exchange traded option.

In turn these terms are built on other terms also defined primarily in s 9. The definition expressly excludes certain swaps and forward rate agreements and provides a power to exclude a class of agreements by regulation. Currently there are no relevant regulations.

TYPES OF FUTURES CONTRACT



Eligible commodity agreement

This covers contracts involving a commodity which is capable of delivery on settlement (for instance, wool, bank bills). The definition also requires that the contract is *likely* to be discharged otherwise than by physical delivery (typically by close out), so that many types of ordinary commercial agreement involving deferred delivery are excluded. The SFE bank bill futures contract is an eligible commodity agreement. However, the definition is not limited to exchange-traded contracts.

Adjustment agreement

Adjustment agreements are contracts which are based on an underlying thing that is not capable of delivery (for example, an index) or whose terms preclude delivery of the thing. These contracts involve a cash adjustment between the parties according to the value of a commodity or level of an index at a future time. The SFE bond futures and Share Price Index (SPI) futures contracts are examples of adjustment agreements. This definition is also not limited to exchange-traded contracts.

Futures option

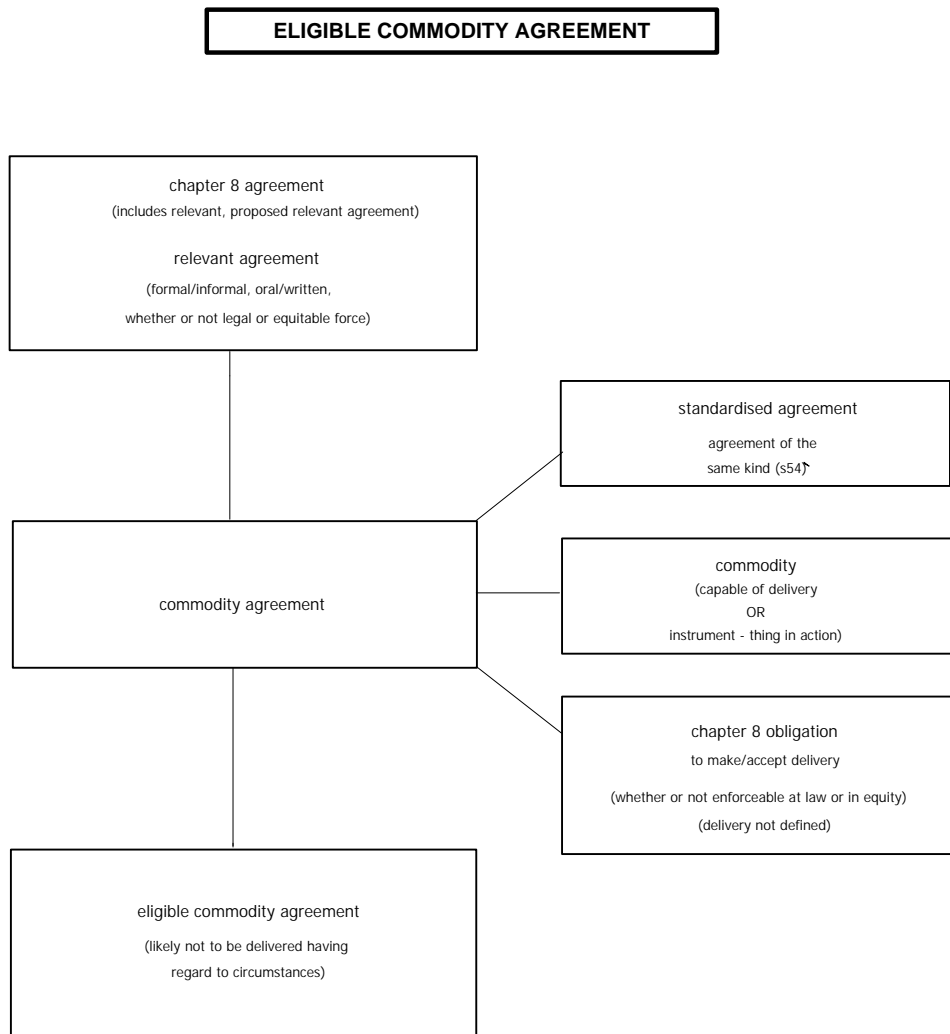
This category covers options over eligible commodity agreements and adjustment agreements. It contrasts with options directly over an asset or index. Thus the SFE SPI option contract is a futures option as it is over a SPI futures contract, not directly over the All Ordinaries Index.

Eligible exchange-traded option

EETOs are options directly over commodities or specified indices, not over futures contracts based on a commodity or index as in the case of a futures option. They must be entered into on a local futures exchange.⁹ For this reason, OTC options cannot be EETOs.

⁹ Eligible exchange-traded options are entered into "on a futures market of a futures exchange": s 9 definition of "eligible exchange-traded option". The definition of "futures exchange" in s 9 is limited to local futures exchanges.

Question: Is it an eligible commodity agreement?



Step 1 - Is it a Chapter 8 agreement?

The definition of "Chapter 8 agreement" uses another defined term, "relevant agreement", broadly defined to encompass any agreement - existing or proposed, formal or informal, oral or written, whether or not enforceable in law or in equity. This broad threshold requirement is easily satisfied.¹⁰

¹⁰ For example, an option to enter into an agreement has been characterised as a proposed agreement and has therefore been held to satisfy the requirement:

Step 2 - Is the agreement a "commodity agreement"?

This question involves three subsidiary questions:

- is the agreement standardised?
- is there a commodity?
- is there a Chapter 8 obligation to make or accept delivery of the commodity?

Is the agreement standardised? Standardisation is a key element in the definition of "futures contract". "Standardised agreement" is defined as an agreement that is one of two or more agreements of the "same kind".¹¹ Agreements are of the same kind where the provisions of one are the same as, or not materially different from, the provisions of the other, disregarding differences in parties and amounts payable.¹² This has been interpreted by the courts to mean that they "are substantially the same and refer to the same type or nature of transaction".¹³ Given this, the test of standardisation is easy to satisfy.¹⁴

Is there a commodity? "Commodity" is defined as any thing capable of delivery pursuant to an agreement for its delivery or an instrument creating or evidencing a thing in action. The concept of "thing that is capable of delivery" has been held "to be limited to items, the legal title to which is capable of being passed by physical delivery of the item or (perhaps) by delivery of a document evidencing title to the item".¹⁵ It has been held that a share is not a commodity.¹⁶ The latter part of the definition indicates that "commodity" is

Carrageen Currency Corporation Pty Ltd v CAC (NSW) (1986) 11 ACLR 298. The consequences of this have been criticised: see discussion at 24.

¹¹ s 9. The term "standardised agreement" does not appear in the definition of "futures contract" in s 72, although it is incorporated in the definitions of "eligible commodity agreement" and "adjustment agreement" in s 9. Futures options must be over eligible commodity agreements or adjustment agreements which must be standardised. The fact that EETOs are traded on an exchange will necessarily mean that they are standardised, although this is not an express requirement of the definition.

¹² s 54.

¹³ *CAC (NSW) v Lombard Nash International Pty Ltd* (1986) 11 ACLR 566 at 569.

¹⁴ Standardisation is discussed further infra at 19-20.

¹⁵ *Sydney Futures Exchange Ltd v Australian Stock Exchange Ltd* (1994) 15 ACSR 206 ("*SFE v ASX*") at 223.

¹⁶ In *SFE v ASX*, Sackville J stated that a share is not a commodity. His Honour acknowledged that it was in accordance with commercial and statutory language to refer to the delivery of shares. Nevertheless, in view of the relevant definitions

not limited to tangible items capable of delivery.¹⁷ An "instrument creating or evidencing a thing in action" would include, for example, bills of exchange. It has been held that a share transfer is not "an instrument creating or evidencing a thing in action".¹⁸

Is there a Chapter 8 obligation to make or accept delivery of the commodity?

A Chapter 8 obligation is any obligation, whether or not enforceable in law or in equity. "Obligation" is given a wide meaning. It has been held that the "key concept ... is that of being bound or under a duty to another person, whether there is a legal mechanism for enforcement of the duty or not".¹⁹ "Obligation" does not, however, include a mere economic imperative to take a certain course of action.²⁰ A conditional obligation to deliver constitutes an obligation to make or accept delivery.²¹ Delivery is not defined.

If the above are all answered in the affirmative a commodity agreement exists.

(notably "option contracts" under the securities definition) and the historical evolution of the regulatory regimes for futures and securities, a share is not a "thing that is capable of delivery" within the definition of "commodity" under the "futures contracts" definition: at 223, 225. Sackville J acknowledged that even if the traditional form of settlement could be regarded as "delivery" of shares, it was difficult to apply the same approach to shares transferred through the ASX FAST and CHESSE electronic transfer and settlement systems because of the different process used to effect settlement: at 226. This matter has since gone on appeal to the Full Federal Court.

¹⁷ Sackville J in *SFE v ASX* confirmed this but stated that "tangible items are at the heart of the concept of 'commodity'": at 224.

¹⁸ *Id* at 226-7. Sackville J drew a distinction between "pre-existing instruments that can be the subject matter of a standardised agreement for sale and purchase (such as bills of exchange) and those that are simply the means of giving effect to a transaction already entered into".

¹⁹ *Id* at 228.

²⁰ *Ibid*.

²¹ *Carrageen Currency Corporation Pty Ltd v CAC (NSW)* (1986) 11 ACLR 298 at 308-309. *Carrageen* involved an option to purchase foreign currency. The obligation to deliver was conditional on the client exercising the option and, in effect, was only an alternative method of settlement to the cash adjustment contemplated by the agreement. In the past the options had, where exercised, always been settled by a cash adjustment as opposed to delivery and in view of the structure of the transaction, it was inconceivable that the client would direct delivery. The Court held that the mere fact that the obligation was conditional on the client both exercising the option and directing delivery did not prevent that conditional obligation from being an obligation to make or accept delivery.

Final Step - Is it an eligible commodity agreement?

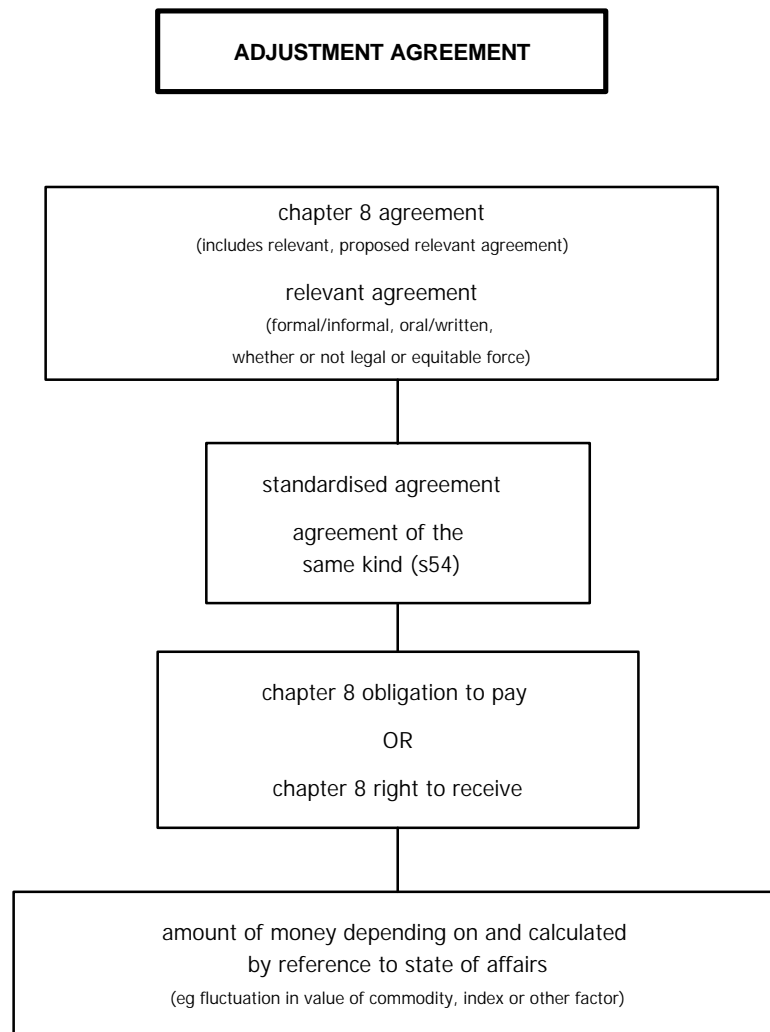
This is defined as a commodity agreement which, when the agreement is entered into (or when an agreement later becomes a commodity agreement), appears likely to be discharged otherwise than by delivery. Discharge otherwise than by delivery will typically occur by close out. Whether an agreement is likely to be closed out must be determined at the time of entry into the agreement (or when it becomes a commodity agreement if this occurs later). In deciding whether close out is likely, one must have regard to all the relevant circumstances, including the terms of the agreement, market practice and how agreements of this kind are generally settled.²² The definition expressly provides that the intentions of the parties are not to be considered. That the parties always intended delivery to occur and it does ultimately occur will not affect the classification of the agreement as an eligible commodity agreement.²³

Conclusion: If a product satisfies all of the above it is an eligible commodity agreement and therefore a futures contract.

²² On one interpretation the reference to "any agreement" in para (c) of the eligible commodity agreement definition means any agreement other than the commodity agreement itself: D Mason & A Pickering, "The Regulation of Derivatives in Australia" (1994) vol 1 no 2 *The Futures and Derivatives Law Review* 53 at 57, note 18.

²³ In *Carragreen*, the eligibility requirement was satisfied as the options had always been settled by a cash adjustment rather than delivery. This case exemplifies the fact that, although there must be an obligation to make or accept delivery, delivery must nevertheless be unlikely (the obligation to deliver being discharged by other means).

Question: Is it an adjustment agreement?



Steps 1 and 2 - Is the agreement a Chapter 8 agreement and is it standardised?

The discussion of these terms under eligible commodity agreement applies to adjustment agreements.

Step 3 - Is there a Chapter 8 obligation to pay or a Chapter 8 right to receive an amount of money?

Chapter 8 rights or obligations are broadly defined and need not be enforceable at law or in equity.²⁴ The definition of adjustment agreement has been interpreted to mean that each party to the agreement must have *both* a potential obligation to pay and a right to receive an amount of money, depending upon the circumstances.²⁵ It will not suffice that a person has a right to receive an amount of money, if he or she will not under other circumstances also be under an obligation to pay. According to this interpretation, an option cannot be an adjustment agreement as the taker (buyer) of the option will only have a potential right to receive (and not an obligation to pay) an amount of money on settlement. Only if the option is profitable will the taker exercise the option: otherwise it will be allowed to lapse.

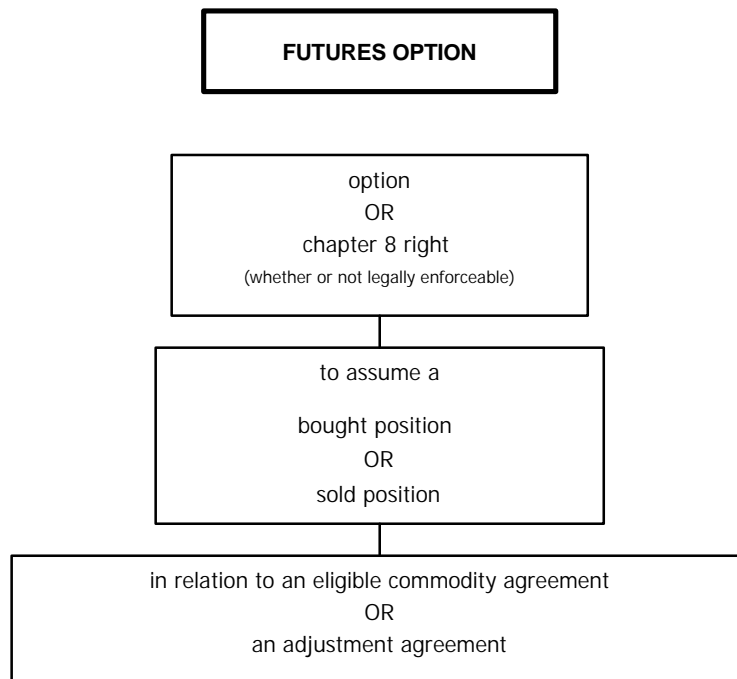
Final step - Is the amount of money calculated in a particular manner by reference to a state of affairs at a particular time?

The obligation to pay or right to receive must depend on a particular state of affairs existing at a particular future time. The determining factor (for instance, movements in an index) and the time must be specified or at least ascertainable from the terms of the agreement.

Conclusion: If the arrangement satisfies all of the above it is an adjustment agreement and therefore a futures contract.

²⁴ s 55.

²⁵ *Carrageen Currency Corporation Pty Ltd v CAC (NSW)* (1986) 11 ACLR 298 at 311; *CAC v Lombard Nash International Pty Ltd (No 2)* (1987) 11 ACLR 866 at 875.

Question: Is it a futures option?*Step 1 - Is there an option or Chapter 8 right?*

"Option" is not defined. In contrast, a Chapter 8 right is defined as any right, whether or not enforceable at law or in equity. This threshold test is not difficult to satisfy.

Step 2 - Is it an option or right to assume a bought or sold position?

A "bought position" is held by a person who is obliged to accept delivery under a commodity agreement or who will have an obligation to pay or a right to receive an amount under an adjustment agreement depending on whether the value of the agreement has decreased or increased. "Sold position" has a corresponding meaning.

The option must specify:

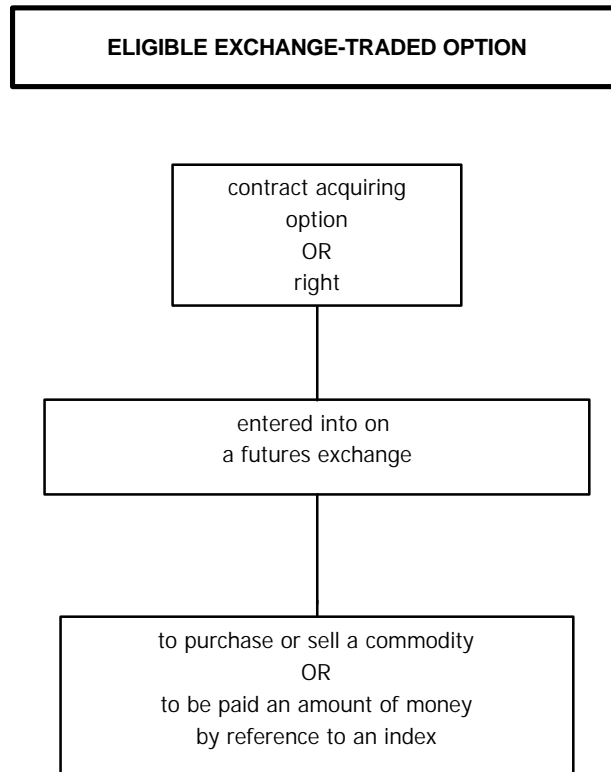
- the price or value at which the bought or sold position is entered into
- the duration of the option or right.

Final step - Is it in relation to an eligible commodity agreement or an adjustment agreement?

The right or option must be over an eligible commodity agreement or an adjustment agreement.

Conclusion: If the product satisfies all of the above it is a futures option and therefore a futures contract.

Question: Is it an eligible exchange traded option?



Step 1- Is there a contract under which a party acquires an option or a right?

"Contract" and "option" are not defined. Also, in this context, "right" is not defined as a "Chapter 8 right". This is not necessary as the contract to acquire the right or option must be traded on a local futures exchange and hence should be enforceable at law or in equity.

Step 2 - Is the contract entered into on a futures exchange?

The contract must be entered into on a futures market of a local futures exchange. Transactions on overseas exchanges do not fall within this category.²⁶

Final Step - Is it a contract to purchase or sell a commodity or to be paid an amount of money by reference to an index?

The contract must be a contract to purchase or sell a commodity or to be paid an amount of money by reference to an index.

Conclusion: If the product satisfies all of the above it is an eligible exchange-traded option and therefore a futures contract. Currently no products meet this definition.

Definition of "securities"

Section 92 exhaustively defines "securities". Three categories relevant to derivatives are:

- option contract within the meaning of Chapter 7
- units of shares of a body corporate
- prescribed interests.

A derivative which is a futures contract cannot be a security.²⁷

Option contract

The three types of Chapter 7 option contract defined in s 9 are:

- (i) an option contract giving a person a right to buy or sell securities at a specified price on or before a specified date (whether or not traded on an exchange)
- (ii) an option contract entered into on a securities exchange (or an exempt stock market) which confers a right to buy or sell an amount of a specified currency or a quantity of a specified commodity at a definite price

²⁶ The definition of "futures exchange" in s 9 is limited to local futures exchanges.

²⁷ The s 92 definition of "securities" excludes futures contracts.

- (iii) an option contract entered into on a securities exchange (or an exempt stock market) which confers a right to be paid an amount determined by comparing a specified number with a specified index.

The second and third types of option contract would be EETOs if entered into on a futures exchange.

Units of shares

Options over issued shares of a corporation may also be units of shares and hence securities.²⁸ A "unit" is defined in s 9 to include "an option to acquire ... a right or interest in the share". In turn, "right or interest" means any right or interest, "whether legal or equitable ... by whatever term called".

Prescribed interests

Although a derivative which is a futures contract cannot be a security, the rights granted pursuant to some futures contracts may nevertheless be prescribed interests.²⁹ Thus, in addition to Chapter 8, the prescribed interest obligations in the Corporations Law apply to these derivatives. Also, OTC derivatives not regulated by Chapter 8 may nevertheless be prescribed interests, depending on the type of joint arrangement between the derivative provider and its clients.³⁰

The prescribed interest obligations include:

- issue of the prescribed interest/futures contract by a public corporation only³¹
- a deed approved by the ASC³²
- a management company and a trustee.³³

²⁸ The ASC has ruled that options to subscribe for unissued shares are not, of themselves, securities of a corporation: ASC Policy Statement 56 para 11.

²⁹ *Carragreen Currency Corporation Pty Ltd v CAC (NSW)* (1986) 11 ACLR 298 at 314-319. The prescribed interest definitions do not exclude futures contracts, as does the s 92 definition of "securities". *Carragreen* held that there was a "participation interest" (one form of prescribed interest) where profits were gained by purchasing and reselling foreign currency under a common enterprise between buyers of foreign currency options (the derivatives) and the promoter of the scheme.

³⁰ *CAC v Lombard Nash International Pty Ltd (No 2)* (1987) 11 ACLR 866 at 876-877.

³¹ s 1064(1).

³² ss 1065, 1066, 1067.

Breach of these requirements may allow parties to void an agreement.³⁴ The ASC may grant exemptions from all or any of these requirements.³⁵

Issues arising under the definitions

Standardisation and fungibility³⁶

The standardisation element was intended to differentiate agreements which should be regulated from the vast array of commercial and consumer agreements which might otherwise fall within the futures contract definition.³⁷

The extensive use of ISDA³⁸ (and to a lesser extent, AIRS³⁹ and ABAFRA⁴⁰) terms for off-exchange derivatives transactions increases the likelihood that they are standardised. Consequently, many of these transactions may be traded OTC only if they fall within the s 72(1)(d) exclusions for certain swaps and forward rate agreements.

The ASC Report on OTC Derivatives Markets (May 1994) (ASC OTC Derivatives Report 1994) points out that:

"The increasing use of the ISDA documentation, the trend towards greater homogeneity in basic products, and the wide interpretation given to the concept of standardisation by the courts, mean that uncertainty about whether or not a transaction is a futures contract will remain a major market issue."⁴¹

³³ A prospectus for the issue of prescribed interests that are futures contracts is not, however, required, as s 1018 prohibits offers of securities (which includes prescribed interests), not prescribed interests as such, without a prospectus. This contrasts with the former provisions in the Companies Code which had separate requirements for a prospectus for shares and debentures (s 96) and a written statement for prescribed interests (s 170).

³⁴ s 1073.

³⁵ s 1084.

³⁶ See also the discussion under the heading "Is the agreement standardised?" supra at 10.

³⁷ Explanatory Paper on Second Exposure Draft of Futures Industry Bill 1985, para 38(b): "Futures contracts, unlike most other forward contracts, are standardised agreements".

³⁸ International Swaps and Derivatives Association.

³⁹ Australian Dollar Interest Rate Terms.

⁴⁰ Australian Bankers Association Forward Rate Agreements.

⁴¹ ASC Report, para 65.

Standardisation may be contrasted with fungibility. Standardisation focuses on an agreement's conformity to one or more other like agreements, although the agreements need not be identical in all respects. Fungibility is concerned with the ability of an agreement to substitute for another agreement. All fungible agreements are standardised, but not all standardised agreements are fungible. For instance, a standardised agreement may include a provision that it not be assigned without the consent of the parties. The prohibition on assignment may prevent that standardised agreement being fungible. A number of submissions on the ASC Discussion Paper on OTC Derivatives argued that the concept of standardisation should be replaced by or incorporate a fungibility criterion.⁴²

ASC Policy Statement 70 on Exempt Futures Markets avoids the terms "standardised" and "fungible" in describing the criteria for an exempt market. One of the matters considered is whether the transaction is individually negotiated by the parties.⁴³ Other factors include whether the transaction:

- is entered into after individual credit assessment of the counterparty
- creates obligations that can be transferred or terminated only with the consent of the counterparty
- is not supported by a clearing house or margining arrangement involving a third party.⁴⁴

The ASC has expressed the view that:

- it would be inappropriate to confine the definition of futures contract to fungible agreements
- the law reform review should consider whether the standardisation element should be removed altogether in defining "regulated derivatives transactions".⁴⁵

Exclusions from the futures contract definition

Paragraph 72(1)(d) expressly excludes from the futures contract definition a Chapter 8 agreement that is:

⁴² Id, para 224.

⁴³ ASC Policy Statement 70, para 60.

⁴⁴ Id, para 62.

⁴⁵ ASC Report, para 225, recommendation 6.

- a currency swap
- an interest rate swap
- a forward exchange rate contract or
- a forward interest rate contract

to which an Australian bank or a merchant bank is a party.

The exclusions were added to the definition just before publication of the final form of the Futures Industry Bill, from which the current provisions were drawn. A number of industry participants had submitted that earlier versions of the definition still caught many commercial and banking transactions not ordinarily considered to be futures contracts. It was decided to expressly exclude particular types of transactions, rather than attempt to redefine a futures contract to exempt ordinary banking and commercial transactions.

The problems in brief

The exclusions:

- are not defined and are uncertain in scope
- are dated and, arguably, unduly limited
- take the specified agreements outside the s 1141 protection of futures contracts from gaming and wagering legislation
- only exempt products from Chapter 8 regulation, not from Chapter 7 regulation as "securities"
- may not include options over the specified agreements
- are inconsistent with recent ASC and overseas policies to provide exemptions only for sophisticated participants.

The problems in detail

The full scope of the exclusions is unknown, as they are not defined terms.⁴⁶

Secondly, the exclusions may not accommodate market developments. They only cover certain types of swaps and forward rate agreements. For instance,

⁴⁶ Hains (supra note 3) argues that there is no consensus on the legal meaning of these terms. Mason & Pickering (supra note 22 at 61) state that the terms currency swap and interest rate swap are well understood in the market and that "forward exchange contracts" means "forward foreign exchange contracts".

commodity swaps⁴⁷ and equity swaps⁴⁸ fall outside the exclusions and may be futures contracts regulated under Chapter 8. Yet they satisfy the rationale for exclusion as, in practice, they are only traded between sophisticated parties and therefore do not raise investor protection concerns.

Thirdly, s 1141, which exempts certain futures contracts from gaming laws, does not cover derivatives falling within the exclusions. Accordingly, those derivatives will be void if they are gaming or wagering contracts.

Fourthly, merely because an agreement falls within the exclusions does not mean it is totally exempt from regulation under the Corporations Law. If it satisfies the definition of "securities", it will be regulated under Chapter 7.

Fifthly, it is unclear whether s 72(1)(d) extends to options on products expressly excluded. If not, the seemingly illogical result is that the option will be regulated, but not its subject matter once the option is exercised. This issue affects options on swaps (swaptions) traded on the OTC market which involve an Australian bank or a merchant bank.

Finally, the exclusions are at odds with ASC Policy Statement 70 on Exempt Futures Markets which only provides relief from Chapter 8 regulation where both parties to the transaction are sophisticated. In contrast, the exclusions only require that one party be an Australian bank or a merchant bank; the other may well be a retail investor. The ASC OTC Derivatives Report 1994 draws attention to this conceptual inconsistency and recommends that the exclusions be repealed.⁴⁹ The exclusions are also inconsistent with recent developments in other jurisdictions where sophisticated participant tests are being developed as the basis for exclusion from regulation.⁵⁰

⁴⁷ A commodity swap is where the fixed rate payer pays a specified amount on payment dates and the floating rate payer pays a fluctuating amount based on the value of an established index on that payment date.

⁴⁸ An equity swap is where the fixed rate payer pays a specified amount on payment dates and the floating rate payer pays amounts calculated by reference to fluctuations in the value of equity securities.

⁴⁹ ASC Report, paras 228-229, recommendation 6.

⁵⁰ For instance, the Ontario Securities Commission's *Report on OTC Derivatives in Ontario* (1994) recommends that certain transactions be exempt from regulation under the Ontario Securities Act, primarily on the basis that they are between sophisticated parties. Also, the US exemption from regulation for swaps applies only where both parties are sophisticated. For details, see Chapters 4 and 5.

Options

The classification of options can be particularly difficult.⁵¹ The wide variety of options exposes possible regulatory gaps. An option over an eligible commodity agreement or an adjustment agreement is a futures option and hence a futures contract. Likewise, an option over a commodity or index which is entered into on a futures exchange is an EETO and hence a futures contract. It is less clear whether other types of options are futures contracts. To answer this question, it is necessary to ask:

- can an option over a commodity be an eligible commodity agreement?
- can an option over a commodity, index or other factor be an adjustment agreement?

Can an option over a commodity be an eligible commodity agreement?

On the assumption that the option agreement is standardised and involves a commodity, the determinative elements will be:

- (i) whether or not there is an obligation to make or accept delivery
- (ii) whether it is likely that the option will be discharged otherwise than by delivery.

Based on *Carragreen*, an option over a commodity may be an eligible commodity agreement, provided it is not compulsorily cash settled.⁵² In

⁵¹ For instance, there are several broad categories of options over equity derivatives:

- cash-settled options (exercise of the option results in a net cash payment rather than physical delivery)
- basket options (the delivery or cash obligation is based on shares of several different companies, referred to as a "basket" of shares, for example the Base Metals Basket Warrant)
- portfolio options (a basket option that is based on a wider range of shares, for example the Olympic 2000)
- index options (the option is based on a share index and must be cash settled as an index cannot be delivered)
- warrants (in Australia, these are exchange tradeable options): J Kriewaldt & R Upfold, "Equity Derivatives: Legal and Taxation Aspects", Paper delivered at AIC Euromoney Conference, 13 July 1994 at 2-3.

⁵² In *SFE v ASX* (1994) 15 ACSR 206 at 223, Sackville J expressed reservations about whether options, either in relation to securities or commodities, were eligible

Carragreen, element (i) was satisfied even though the obligation was conditional on the exercise of the option.⁵³ Likewise, element (ii) was satisfied as the option was likely to be discharged otherwise than by delivery.

Carragreen has been criticised on the basis that options should be regulated as futures contracts only if they fall within the definition of futures option or EETO. Some arguments in support of this view are:

- this was the intention of the original legislation
- the Explanatory Memorandum to the Futures Industry Bill 1986 (on which the current Corporations Law definitions are based) appears to acknowledge that deliverable commodity options were not to be regulated under the Futures Industry Code.⁵⁴

Conclusion: Opinions differ about whether an option over a commodity can be an eligible commodity agreement. It is, however, possible to ensure that an option is not an eligible commodity agreement by making cash settlement compulsory, thereby precluding an obligation to make or accept delivery (element (i)). This is subject to the qualification that a court would consider the substance as well as the form of the transaction in deciding whether there was an obligation to deliver.⁵⁵

Can an option over a commodity, index or other factor be an adjustment agreement?

The relevant part of the definition of adjustment agreement is the requirement that the agreement have the effect that a person either is under an obligation to pay or has a right to receive an amount of money depending upon a future state of affairs.

In *Carragreen*, Hodgson J interpreted this requirement to mean that "it is not sufficient that [such] person merely have a right to receive an amount of

commodity agreements. However, His Honour did not overrule what was said in *Carragreen* on this point.

⁵³ The obligation was also conditional upon a direction from the client that delivery of the currency was to be made, rather than the currency "re-sold" in what operated in practice as a cash adjustment.

⁵⁴ M Hains, "Options - Should they be treated as futures contracts?", *Banking Law Association Special Report 1992* at 21-24; Kriewaldt & Upfold, *supra* note 51 at 9; *SFE v ASX* (1994) 15 ACSR 206 at 223.

⁵⁵ *Shoreline Currencies (Aust) Ltd v CAC* (1986) 10 ACLR 847 at 857-858.

money, if he will not under other circumstances also be under an obligation to pay".⁵⁶

The taker (buyer) of an option has a potential right to receive money, but no obligation to pay money other than the premium (a fixed amount paid when the option is entered into). The writer (seller) of the option has a potential obligation to pay money, but no right to receive money other than the premium. Thus the taker will never have an obligation to pay an amount of money based on a particular future state of affairs. Likewise, the writer will never have a corresponding right to receive money. In summary, at the maturity of the option:

- if the option is "in the money" and hence is exercised, the writer will have an obligation to pay and the taker will have a right to receive
- if the option is "out of the money" and hence is not exercised, neither party will have an obligation to pay and neither party will have a right to receive.

Thus, on the *Carragreen* test, an option cannot be an adjustment agreement.

The decision has been criticised as failing to consider that out of the money options will not be exercised and as ignoring the option writer's obligation.⁵⁷ However, Hodgson J's interpretation is supported by other authors⁵⁸ as well as the Explanatory Memorandum to the Futures Industry Bill, which commented on the definition in the form it appears in the Corporations Law:

"It should be noted that contracts or agreements under which the only possible results are that a particular party pays, or does not pay, at a particular time (eg an insurance or superannuation contract) would fall outside the definition."⁵⁹

⁵⁶ *Carragreen Currency Corporation Pty Ltd v CAC (NSW)* (1986) 11 ACLR 298 at 311. The decision in *Carragreen* was applied in *CAC (NSW) v Lombard Nash International Pty Ltd* (1986) 11 ACLR 566 and *CAC (NSW) v Lombard Nash International Pty Ltd (No 2)* (1987) 11 ACLR 866.

⁵⁷ Hains, *supra* note 54 at 20-21.

⁵⁸ J Currie, *Australian Futures Regulation* (Longman, 1994) at 40; J O'Sullivan, "Derivatives - A Survey of the Law and Practice" (1994) 5 *Journal of Banking and Finance Law and Practice* 94.

⁵⁹ Explanatory Memorandum to Futures Industry Bill 1986 para 30(b).

In *SFE v ASX*, Sackville J expressed support for the view that options, in relation to either securities or commodities, are not adjustment agreements.⁶⁰

Conclusion: The preponderance of authority is that options cannot be adjustment agreements.

Classification of off-exchange compulsorily cash settled options

Off-exchange compulsorily cash settled options appear not to fall within the definition of "futures contract" or of "securities".

They are not futures contracts as:

- they are not eligible commodity agreements or adjustment agreements for the reasons given above
- they are not futures options, as they are not options over an eligible commodity agreement or adjustment agreement
- they are not EETOs, as they are not exchange-traded.⁶¹

They are also not "securities" falling within Chapter 7 option contracts as:

- being compulsorily cash settled, they are not type (i) option contracts (see supra at 17) as the buyer of the option has no right to buy or sell the securities themselves
- they are not type (ii) option contracts, for reasons similar to those given for type (i) option contracts and as they are not traded on a securities exchange (or an exempt stock market)
- they are not type (iii) option contracts as they are not traded on a securities exchange (or an exempt stock market).

Also, they are not units of shares as they do not give a right to shares of a particular corporation.

The ASC has recommended that the law reform review should examine the current regulatory treatment of options and clarify the extent to which options should be "regulated derivatives transactions".⁶²

⁶⁰ *SFE v ASX* (1994) 15 ACSR 206 at 223.

⁶¹ One commentator describes this as a "loophole" which has the effect that "designers of derivatives can readily avoid Chapter 8 of the Corporations Law entirely": O'Sullivan, supra note 58.

Interaction of the definitions

The original intention of the legislation was to draw a clear distinction between futures contracts and securities.⁶³ The mechanism chosen to avoid double regulation was the exclusionary phrase at the end of the s 92 definition of "securities", namely "but does not include a futures contract...". There are doubts whether a product to which *both* the "futures contract" and "securities" definitions potentially apply is a futures contract or a security. There are two possible interpretations.

- (i) *The futures contract definition prevails.* If an agreement falls within any of the paragraphs (a) to (e) of the s 92(1) definition of "securities" and also falls within the definition of "futures contract", it will be a futures contract and *cannot* be a security because of the exclusory words.⁶⁴
- (ii) *Specific securities definitions prevail.* This argument has been advanced in the context of options: "The general exclusion of 'futures contracts' from the definition of 'securities' must give way to the specific inclusion in the definition of 'securities' of 'option contracts within the meaning of Chapter 7'".⁶⁵

The Corporations Law (Securities and Futures) Amendment Bill 1994 is intended to permit particular exchange-traded agreements to be regulated as if they were securities or futures contracts. Its immediate purpose is to permit the trading of share ratios on the ASX.⁶⁶

⁶² ASC Report, para 230, recommendation 6.

⁶³ This is reflected in the Explanatory Memorandum to the Futures Industry Bill 1986 (para 9) which stated that:

"It is not practicable to attempt to incorporate the futures legislation into the [securities provisions]. To do so would ... fail to take account of the differences between the futures and securities markets. Whereas securities markets are concerned with the transfer of title in property, a major function of a futures market is to facilitate risk management rather than enable title in property to be transferred."

⁶⁴ See, for instance, Hains, *supra* note 54 at 22; C Hamilton, "Understanding the derivatives amendments to the Corporations Law" (1994) 10 *Butterworths Corporations Law Bulletin* 182 at 183: "Thus if a new derivative product is, or could be, a futures contract, then it does not matter whether it could also be a security."

⁶⁵ O'Sullivan, *supra* note 58 at 98.

⁶⁶ A share ratio is a cash settled equity derivative which will be traded on the ASX through its Securities Exchange Automated Trading System and cleared through the Options Clearing House. The value of a share ratio depends on the ratio of

Content of regulation

This section of the Chapter compares derivatives regulation under Chapter 7 and Chapter 8. The ASC OTC Derivatives Report 1994 notes that the two regimes have many common features, including:

- prohibiting the establishment of unauthorised markets
- the licensing of market intermediaries (brokers and advisers)
- requiring licence holders to take responsibility for the acts of representatives
- requiring the separation of clients' and brokers' funds
- ensuring that brokers give clients details of trading
- requiring the establishment of a fund to compensate clients who have suffered loss as a result of a "defalcation or fraudulent misuse of money" by a member of an exchange
- providing a statutory framework for industry co-regulation by self-regulatory organisations and the ASC
- prohibiting certain abusive behaviour, including market manipulation, false trading, market rigging or making false or misleading statements.⁶⁷

The discussion in this Chapter focuses on key differences between futures and securities legislation.

Exchange-trading requirement

Securities may be traded on or off a stock exchange. By contrast, a futures broker may only deal in futures contracts on a futures exchange, an exempt futures market or in accordance with the rules of a futures organisation.⁶⁸

The SFE is the only Australian futures exchange currently operating.⁶⁹

movements in the price of a particular quoted security to movements in a designated index (such as the All Ordinaries Index).

⁶⁷ para 52.

⁶⁸ s 1258.

⁶⁹ The Australian Financial Futures Market does not currently operate. When it was established in September 1985, it offered futures contracts over shares of leading Australian companies. Futures contracts and options on futures traded on the SFE include:

- 90-Day Bank Accepted Bills
- Ten-Year and Three-Year Treasury Bonds

Securities may be traded on the ASX. Options within the meaning of Chapter 7 may be traded on the Australian Options Market (AOM), a subsidiary of the ASX.⁷⁰

Clearing houses

Both the SFE and the AOM have clearing houses, Sydney Futures Exchange Clearing House and Options Clearing House respectively. They guarantee performance of the relevant futures or option contracts.

Clearing houses operate by novation. The original contract is replaced by two contracts, being a contract between the seller and the clearing house and a contract between the buyer and the clearing house. Rights of parties to the original contract do not depend on the other party's ability to honour its terms. The exchanges operate margining systems.⁷¹

Futures contracts disclosure

The regulation of futures contracts under Chapter 8 focuses on risk disclosure whereas the regulation of securities under Chapter 7 requires prospectus disclosure.

Section 1210⁷² provides that:

A futures broker shall, before accepting a person⁷³ as a client⁷⁴ of the broker, give to the person:
(a) a document that:

-
- . the All Ordinaries Share Price Index (SPI)
 - . the Fifty Leaders Share Price Index (FLI).

Futures are also traded on wool and live cattle.

⁷⁰ Options over individual stocks, the All Ordinaries Index and the Gold Share Price Index are currently traded on the AOM.

⁷¹ Margining systems significantly lower the risk of individual market participant failure and therefore systemic risk. For instance, the ASX Options Clearing House margins market positions daily through the Theoretical Intermarket Margining System (TIMS). TIMS allows both end-of-day and intra-day mark-to-market margining of ASX's clearing house members and through them their clients.

⁷² Based on s 87 of the forerunner Futures Industry Code 1986.

⁷³ Defined in s 85A to include a body politic or corporate as well as an individual.

⁷⁴ Under s 9, a "client" of a futures broker is a person on whose behalf the broker deals, or from whom the broker accepts instructions to deal, in futures contracts.

(i) *explains the nature of futures contracts;*

- (ii) *explains the nature of the obligations assumed by a person who instructs a futures broker to enter into a futures contract;*
- (iii) *sets out a risk disclosure statement in the prescribed form;⁷⁵*
and
- (iv) *sets out the specifications, and details of the essential terms, of each kind of futures contract in which the broker deals on behalf of clients; and*
- (b) *a copy of each agreement into which the broker proposes, if the broker agrees to accept instructions from the person in relation to dealings in futures contracts, to require the person to enter.*

The purpose of the section is to ensure that clients are aware that futures trading involves the risk of loss as well as the prospect of profit.⁷⁶

The disclosure obligations, imposed on futures brokers but not on persons who are only futures advisers, only relate to derivatives that fall within the definition of futures contract. Two types of documents must be given to the prospective client:

- . an explanatory/risk disclosure document⁷⁷
- . a customer agreement.⁷⁸

Explanatory/risk disclosure document

This document in practice contains three parts:

- . a general explanatory statement
- . a prescribed risk disclosure statement
- . a specifications statement.

General explanatory statement

Futures brokers must explain the nature of futures contracts and client obligations.⁷⁹ The SFE has produced a "Futures Trading Explanatory

⁷⁵ See Form 804 set out infra note 81.

⁷⁶ Explanatory Memorandum to the Corporations Bill 1988, para 3623.

⁷⁷ s 1210(a).

⁷⁸ s 1210(b).

⁷⁹ s 1210(a)(i) and (ii).

Document and Risk Disclosure Statement", which is generally used in practice.⁸⁰

Prescribed risk disclosure statement

Futures brokers must give a risk disclosure document in the prescribed form.⁸¹ This supplements a broker's common law obligations to disclose the nature of the risks associated with futures dealing.⁸²

⁸⁰ SFE Practice Note 10. One commentator has suggested some refinements to that document: M Hains, *Butterworths Australian Corporations Law: Principles and Practice* vol 3 at [8.1.0215].

⁸¹ s 1210(a)(iii), Form 804 of the Second Schedule to the Corporations Regulations. The prescribed form reads:

FORM 804

This statement is given to you as required by section 1210 of the Act.

The risk of loss in trading in futures contracts can be substantial. You should therefore carefully consider whether that kind of trading is appropriate for you in the light of your financial circumstances. In deciding whether or not you will become involved in that kind of trading, you should be aware of the following matters:

- (a) You could sustain a total loss of the initial margin funds that you deposit with your futures broker to establish or maintain a position in a futures market.
- (b) If the futures market moves against your position, you may be required, at short notice, to deposit with your futures broker additional margin funds in order to maintain your position. Those additional funds may be substantial. If you fail to provide those additional funds within the required time, your position may be liquidated at a loss and in that event you will be liable for any shortfall in your account resulting from that failure.
- (c) Under certain conditions, it could become difficult or impossible for you to liquidate a position (this can, for example, happen when there is a significant change in prices over a short period).
- (d) The placing of contingent orders (such as a "stop-loss" order) may not always limit your losses to the amounts that you may want. Market conditions may make it impossible to execute such orders.
- (e) A "spread" position is not necessarily less risky than a simple "long" or "short" position.
- (f) The high degree of leverage that is obtainable in futures trading because of small margin requirements can work against you as well as for you. The use of leverage can lead to large losses as well as large gains.
- (g) If you propose to trade in futures options, the maximum loss in buying an option is the amount of the premium, but the risks in selling an option are the same as in other futures trading.

This statement does not disclose all of the risks and other significant aspects involved in trading on a futures market. You should therefore study futures trading carefully before becoming involved in it.

Specify here:

The prescribed form goes beyond the strict obligations of s 1210 by requiring a broker to explain the futures contracts trading terms used in the risk disclosure statement and requiring the prospective client to sign the statement.⁸³ Obtaining the client's signature may be prudent for the broker.⁸⁴

Specifications statement

Futures brokers must specify details of the essential terms of each kind of futures contract in which the broker deals on behalf of clients.⁸⁵ The broker must give a prospective client specifications of all futures contracts in which the broker deals on behalf of clients, not just those in which the client proposes to trade. The requirement relates only to futures contracts as defined in s 72, not, for instance, to contracts falling within the s 72(1)(d) exclusions. The SFE has produced a description of its own products for this purpose.

-
- (a) Full name(s) of the prospective client(s) (please print):
 (b) Date on which the statement is given to the prospective client:
 (c) Signature of the futures broker by whom this statement is given:
 (d) Full name and the address of the futures broker by whom this statement is given: (include State or Territory and postcode):
 *I/*We confirm that *I/*we have read and understand this risk disclosure statement and that the futures contracts trading terms used in it have been explained to *me/*us by the giver of this statement.
 (signature of the prospective client)
 (under the signature add the date on which the statement is signed by the prospective client)

⁸² A broker is obliged to explain the existence and effect of variation margin calls to a client who is unfamiliar with trading in futures contracts. That duty probably means that a broker must explain the nature and effect of both initial and variation margin calls: *Rest-Ezi Furniture Pty Ltd v Ace Shohin (Australia) Pty Ltd* (1987) 5 ACLC 10. A broker may have a duty to advise clients of price movements in special circumstances: *Oabate Pty Ltd v Nichols Commodities Pty Ltd* (November 1983, Supreme Court of NSW).

⁸³ Currie, *supra* note 58 at 169; Hains, *supra* note 80. SFE Practice Note 10 states that "it was the intent of [the Futures Industry Code] to require such signature".

⁸⁴ Hains, *supra* note 80, suggests two reasons why it is prudent to have the client sign the risk disclosure statement:

- the broker can establish compliance with s 1210
- the broker can establish the disclosure of risks if the broker is sued for negligence.

⁸⁵ s 1210(a)(iv).

Criticisms of risk disclosure requirements

Criticisms of s 1210(a) include that:

- there is no indication how long before accepting a person as a client the risk disclosure document should be given⁸⁶
- there are no guidelines on how much detail is required⁸⁷
- there is no obligation to update the document to correct information which has become materially inaccurate or incomplete in any respect after the person has been accepted as a client⁸⁸
- the obligation to give a specifications statement may be burdensome where a broker deals in a diversity of markets⁸⁹
- the obligation to give a specifications statement may be unnecessary given other legislative and SFE disclosure requirements.⁹⁰

Managed discretionary accounts

In 1991 the SFE introduced rules imposing additional disclosure requirements for Managed Discretionary Accounts.⁹¹ This followed an ASC class order⁹² pursuant to s 1084 relieving offerors of Managed Discretionary Accounts (arguably prescribed interests) from the following Chapter 7 requirements:

- the obligation to lodge and register a prospectus
- the advertising provisions
- the securities hawking prohibition
- the requirement that application money be held in a separate bank account
- the public corporation and approved deed provisions.

⁸⁶ Currie, *supra* note 58 at 169-170. A new client may not fully appreciate the risks if the document is given either too close to or too long before the first dealing.

⁸⁷ Some suggestions are given by Hains, *supra* note 80.

⁸⁸ Contrast SFE By-Law G.35 for Managed Discretionary Accounts.

⁸⁹ Hains, *supra* note 80.

⁹⁰ For example, ss 1206 (to provide contract notes) and 1207 (to provide monthly statements); Article 3.6(2)(g) (not to misadvise or mislead clients) and Article 3.6(3)(k) of the SFE Business Rules (to submit client agreements).

⁹¹ SFE Article 1.1 defines a Managed Discretionary Account as "a trading account over which the client gives a member authority to effect transactions in futures contracts or options without prior reference to or approval of the client".

⁹² ASC Instrument No. 92/1015.

This relief was granted on condition that the SFE would amend its rules to:

- prohibit the operation of a Managed Discretionary Account until the prospective client has received a prescribed disclosure document and a CAF is in force⁹³
- impose a suitability rule⁹⁴
- require that the disclosure document bear a date prior to the date of its first use and that, in general, the information be current to that date⁹⁵
- require that the disclosure document be corrected where it has become materially inaccurate or incomplete in any respect and that the amended document be forwarded to the client⁹⁶
- only permit trading in such accounts on an individual basis (thereby excluding pooled funds).⁹⁷

In its earlier report on the Public Hearing on Discretionary Futures Accounts, the ASC stated that the disclosure document must contain all such information in relation to futures trading as a client would reasonably require and reasonably expect to find in such a document.⁹⁸ The prescribed disclosure document,⁹⁹ a form of modified prospectus, must accompany the CAF and disclose:

- the member's principal trading
- the member's organisational structure
- management and control of accounts
- all fees, commissions and expenses
- trading strategies
- past accounts in the form of performance tables
- the risks associated with foreign futures and options (where traded)

⁹³ By-Law G.32(a)(i), (ii).

⁹⁴ By-Law G.31(a)(iii).

⁹⁵ By-Law G.37.

⁹⁶ By-Law G.35.

⁹⁷ The definition of "Managed Discretionary Account" in SFE Article 1.1 excludes "(iv) a discretionary account involving the pooling of client monies for the purpose of investment in futures contracts".

⁹⁸ Report on the Public Hearing on Discretionary Futures Accounts [1991] *ASC Digest* vol 2, Public Hearing 12, para 74(d).

⁹⁹ SFE By-Laws G.32(a)(i), G.33. The full text of the disclosure document is in the 24th Schedule to the SFE Business Rules.

- the specifications and essential terms of each kind of futures and options contract in which the member intends to deal.

Customer agreements

A broker must give a prospective client a copy of each agreement it proposes to enter into with the client.¹⁰⁰ A broker cannot accept a person as a client unless a client agreement form (CAF) is in force.¹⁰¹ A new CAF need only be given where the original CAF is to be altered (for instance, where the client wants to change from discretionary to non-discretionary trading) or where any of the prescribed terms for the CAF are altered.

Content of client agreement forms

The content of CAFs is governed by the SFE Business Rules and depends primarily on the nature of the parties to the transaction (for instance, broker/client, introducing broker/principal broker) and the type of account (for instance, discretionary or non-discretionary).¹⁰² All client agreements

¹⁰⁰ s 1210(b), SFE Business Rules 3.6(3)(k)(i), 4.6(4)(h)(i), 4A.7A(4)(g)(i).

¹⁰¹ SFE Business Rules 3.6(3)(k)(ii) & (ka), 4.6(4)(h)(ii) & (ha), 4A.7A(4)(g)(ii) & (ga).

¹⁰² SFE precedent form agreements in the schedules to the rules have been replaced by a narrative description, set out in Pt B of the First Schedule to the SFE Business Rules, of the minimum clauses an agreement should contain. Some clauses apply to particular types of parties, others are common to all parties. Provisions relevant to all client agreements include an acknowledgement by the parties that:

- dealing in futures or option contracts may create an obligation to give or take delivery or make a cash adjustment
- the SFE member will incur a personal obligation when dealing on behalf of the client
- rights or benefits obtained by a member on registration of a contract with the clearing house are personal to the member
- once contracts are registered the client has no rights against any person or body other than the member
- trading in futures and option contracts incurs the risk of loss as well as the prospect of profit
- the member may, in its absolute discretion, call for margin payments or close out
- the member has the right to refuse to deal
- either party may terminate the agreement at any time
- the client has formed the opinion that futures and options trading is suitable for its purposes.

Provisions relevant to discretionary accounts include:

- the extent of discretion to be exercised by the member

must include specific information, including the rights and obligations of the parties for on-market trading.

Particular rules apply where the client is itself an SFE member (for instance, where a floor member agrees to execute a trade on behalf of a clearing member).¹⁰³

The rules governing CAFs prohibit provisions which purport to limit or exclude the liability of a member for negligence, fraud or dishonesty in relation to the member's activities as a futures broker or a futures adviser.¹⁰⁴

The SFE rules relating to client documentation bind all SFE members, whether acting as brokers or providing futures advice.¹⁰⁵ One commentator has criticised the prescribed terms as not properly covering the giving of advice.¹⁰⁶ The SFE rules do not apply to futures advisers who are not SFE members.

Acknowledgment of risk by client

Clause 1.9 of the prescribed terms for CAFs provides for:

"An acknowledgment by the Client that the Client has given consideration to the Client's objectives, financial situation and needs and has formed the opinion that dealing in futures or option contracts is suitable for the Client's purposes."

This is a reverse of the suitability rule for securities.¹⁰⁷ It requires the client rather than the broker to consider the client's financial objectives and needs. This clause, together with a risk disclosure statement signed by the client, reduces the possibility of a client successfully suing a broker in negligence.

. limitations on the member's discretion.

¹⁰³ A "Deemed Member Client Agreement", set out in Pt BB of the First Schedule, comes into effect if a member and a member client fail to execute a CAF. The agreement only permits non-discretionary trading.

¹⁰⁴ Articles 3.6(3)(k), 4.6(4)(h), 4A.7A(4)(g).

¹⁰⁵ SFE Articles of Association, First Schedule, Pts C and CB.

¹⁰⁶ Currie, *supra* note 58 at 180. Currie notes that giving futures advice forms part of the business of a substantial number of SFE brokers.

¹⁰⁷ s 851.

Securities disclosure

Risk disclosure

The Corporations Law contains no risk disclosure requirements for securities. However, the ASX imposes risk disclosure requirements for warrants trading. Warrants in Australia mean long-dated call or put options issued by a financial institution over shares, a basket of shares or an index and traded on the ASX.¹⁰⁸ There are separate ASX risk disclosure Explanatory Booklets for index and equity warrants. A broker must not accept an order to buy or sell a warrant unless the client has been given a copy of the relevant booklet.¹⁰⁹ The booklets give detailed information about:

- the types, trading, purposes and uses of warrants
- the warrant issuer's obligations
- the risks of warrants trading and
- the exercise and settlement of warrants.

Customer agreements

There are no Corporations Law requirements for securities customer agreements. However, ASX rules stipulate that an ASX member must not accept an order from a client to buy or sell a warrant unless the client has signed an agreement in the prescribed form,¹¹⁰ which contains a number of acknowledgments by the client, including that the client has read the Explanatory Booklet.

Prospectus-type disclosure

Statutory obligations

The effect of s 1018 is that all offers or invitations to subscribe for or purchase securities require a prospectus if:

¹⁰⁸ They may be distinguished from:

- "share warrants" (a form of bearer security)
- company-issued options to subscribe for shares and
- options traded on the AOM.

¹⁰⁹ ASX r 8.14.1.

¹¹⁰ ASX r 8.14.1, Appendix 6.17.

- they are securities of a corporation and
- the offer or invitation has not been exempted.

The generally accepted view is that the s 1018(1) reference to "securities of a corporation" applies the definition of securities in s 92(2), not that in s 92(1).¹¹¹ This is particularly significant for derivatives that are securities, as only s 92(1) includes "an option contract within the meaning of Chapter 7". Subsection 92(2) does, however, include "units of shares". "Unit" is defined in s 9 to include an option to acquire a right or interest in a share. Options over issued shares fall within s 92(2) and therefore require a prospectus. The ASC considers that an offer of options to subscribe for unissued shares also requires a prospectus.¹¹² It also takes the view that the prospectus provisions do not apply to warrants and does not accept lodgement of offering circulars for warrants.

The Advisory Committee Prospectus Sub-Committee Report (1992) recommended that s 1018(1) be amended to expressly cover:

- options and other rights or interests in respect of unissued securities and
- warrants and similar rights in respect of issued securities.

The prospectus requirements only apply to primary offers or invitations of s 92(2) securities of a corporation. No prospectus is required for secondary offers of quoted securities.¹¹³ Secondary trading in unquoted securities, including prescribed interests, will in most instances only require a notice by the seller.¹¹⁴

All primary offers or invitations that fall with s 66 or Corp Reg 7.12.05 or 7.12.06 are excluded from the prospectus obligations, for instance, offers involving minimum subscriptions of A\$500,000. All offers or invitations

¹¹¹ The s 92(2) definition applies rather than the s 92(1) definition when the expression "securities" is used in relation to a "body". A "body" is defined in s 9 to include a body corporate. A corporation is defined in s 9 to include any body corporate. Thus the reference in s 1018(1) to "securities of a corporation" attracts the s 92(2) definition of securities of a body.

¹¹² The offer of options to subscribe for unissued shares involves the offer of the underlying shares, thereby requiring the lodgement of a prospectus at the time of the offer of options: ASC Policy Statement 56 para 11(a).

¹¹³ s 1018.

¹¹⁴ s 1043D.

issued by Australian banks in the ordinary course of their banking business are exempt from the prospectus provisions.¹¹⁵ Also, the ASC has granted a conditional prospectus exemption for Australian futures brokers offering certain discretionary futures trading accounts to clients.¹¹⁶

The Corporations Law imposes a general non-prescriptive obligation on a prospectus issuer to include relevant information in the prospectus, taking into account the nature of the securities and the kind of persons likely to acquire them.¹¹⁷ There are also controls on advertising securities subject to a prospectus,¹¹⁸ and holding application money.¹¹⁹

The prohibition on hawking unquoted securities does not apply to offers (whether primary or secondary) of securities made by whatever means by a licensed dealer, to a person who has:

- bought or sold securities through the dealer in the preceding 12 months or
- entered into a written agreement, still in force, with the dealer under which the dealer may act for or advise that person in connection with securities.¹²⁰

The ASC may impose licence conditions to further regulate this exemption.¹²¹

ASX obligation: warrants

The ASX warrant rules¹²² have particular disclosure requirements. The warrant issuer must issue an Offering Circular "to which the Exchange has no objection".¹²³ The terms of issue of a warrant stem from that Circular. The

¹¹⁵ s 1083.

¹¹⁶ ASC Instrument 92/1015. The ASC viewed these accounts as prescribed interests requiring a prospectus unless exempted.

¹¹⁷ s 1022.

¹¹⁸ s 1025, 1026.

¹¹⁹ s 1043.

¹²⁰ s 1078(3A).

¹²¹ s 786.

¹²² ASX Business Rules Section 8.

¹²³ r 8.7.1. Under r 8.7.12, the ASX reserves the right to require the inclusion of additional information in the Offering Circular.

Circular must be given to all persons offered or invited to subscribe to the initial issue.¹²⁴

¹²⁴ r 8.7.2.

The Offering Circular is similar to a prospectus in several respects. It must contain a statement that no warrants will be issued on the basis of the Circular later than 6 months after the date of the Circular.¹²⁵ The Circular must:

"contain all such information as investors and their professional advisers would reasonably require and reasonably expect to find in the Offering Circular for the purpose of making an informed assessment of:

- (a) the capacity of the Warrant-Issuer to fulfil the obligations specified in the Terms of Issue; and
- (b) risks, rights and obligations associated with the Warrant".¹²⁶

There are also detailed content requirements for Offering Circulars.¹²⁷

Fees and benefits

Securities dealers and futures brokers must disclose their fees.¹²⁸

A securities adviser who makes a recommendation must disclose to the client:

¹²⁵ r 8.7.4.

¹²⁶ r 8.7.5. Cf s 1022 which refers to "(a) the assets and liabilities, financial position, profits and losses, and prospects of the corporation and (b) the rights attaching to the securities".

¹²⁷ r 8.7.10(n). These include that there be clear and comprehensive information about:

- the warrant-issuer and its commercial activities
- the warrant
- the underlying financial instrument
- the National Guarantee Fund and the fact that it is not a guarantor in all cases
- guarantees (if applicable)
- risk factors relating to the warrant
- tax considerations
- extraordinary events
- potential conflicts of interest
- suspension, discontinuance or modification of the underlying financial instrument
- takeover of listed entity (if applicable)
- delisting of listed entity (if applicable)
- treatment of dividends (if applicable)
- associations arising as a result of warrant trading (if applicable).

¹²⁸ s 842(3)(j); s 1206(3)(h) and SFE By-Law G.41(a)(ii).

- particulars of any commission, fee, or other benefit that may arise from the client acting on the recommendation or
- any other pecuniary or other interest of the adviser which may affect the recommendation.¹²⁹

There is no equivalent in Chapter 8 for futures advisers.

Transaction reporting

Contract notes

Both futures brokers and securities dealers must provide contract notes to the persons for whom they are acting, with certain exceptions.¹³⁰ Also, securities dealers must give a contract note to the counterparty where the transaction is not in the ordinary course of business on the stock exchange, whether or not the dealers are acting as principal. There is no equivalent counterparty requirement for futures brokers.

There are marked differences in the information that must be contained in a futures and a securities contract note. Securities contract notes are standard, regardless of the type of securities involved.¹³¹ However, futures contract notes differ depending upon whether they relate to futures options,¹³² eligible exchange-traded options¹³³ or one of the other types of futures contract.¹³⁴ A contract note relating to an option that is a futures contract will include the following material information that need not appear on a contract note for a Chapter 7 option contract:

¹²⁹ s 849.

¹³⁰ ss 1206 and 842. Futures brokers need not give contract notes where the person for whom they are acting is also a futures broker: s 1206(2). There is no equivalent exemption for securities dealers. Securities dealers need not give contract notes for the sale or purchase of securities or prescribed interests that are made available in accordance with the prospectus and prescribed interest provisions in Pt 7.12 Divs 2 and 5: Corp Reg 7.4.02.

¹³¹ s 842(3).

¹³² s 1206(4).

¹³³ s 1206(5).

¹³⁴ s 1206(3).

- a description of the subject matter to which the option relates¹³⁵

¹³⁵ In the case of a futures option, this will be a description of the class of futures contract to which the option relates and the month and year for performance or settlement of the futures contract to which the futures option relates.

- the date by which the purchaser of the option must declare an intention to exercise the option
- the option's exercise price.

Thus, in the case of exchange-traded options, there would be different contract note requirements depending on whether the option is traded on a securities exchange or a futures exchange (although currently no EETOs are traded on the Sydney Futures Exchange).

Monthly statements

Futures brokers must send monthly statements to their clients where they have held money or property on the client's account during the month or have the client's authority to operate a discretionary account.¹³⁶ Matters covered by these statements include:

- the cash balance at the beginning and end of the month
- all deposits, credits, withdrawals and debits during the month
- a description of any futures contract acquired during, and still held at the end of, the month, including a description of the subject matter of the contract, the contract price or premium and, in the case of an option, its exercise price
- details of outstanding deposit or margin calls.

Securities dealers are not required to send monthly statements to their clients.

The ASC OTC Derivatives Report 1994 considered that all licensees dealing in OTC derivatives should be obliged to send regular reports to retail investors.¹³⁷ In addition, it suggested that consideration be given to requiring derivatives licensees to inform retail investors of major changes which may affect the amounts that the investors are entitled to receive or are obliged to pay under the derivatives contract.¹³⁸

¹³⁶ s 1207.

¹³⁷ para 260.

¹³⁸ para 261.

Suitability

Statutory requirements

Futures

The First Exposure Draft of the Futures Industry Bill 1985 proposed requiring a futures broker to "make the prescribed inquiries" before accepting a person as a client for dealing in futures contracts.¹³⁹ The proposed "prescribed inquiries" included a requirement that the broker obtain information from the client to enable the broker to determine the client's creditworthiness and suitability for dealing in futures contracts. This requirement was omitted from the Second Exposure Draft of that Bill and subsequently. The Explanatory Paper said that "the 'know your client' requirement was considered too onerous and impractical."¹⁴⁰ There is no futures suitability requirement in the Corporations Law. However, there is an SFE suitability requirement for managed discretionary accounts.¹⁴¹

Securities

A securities dealer or adviser is subject to a general suitability requirement in making a securities recommendation.¹⁴²

¹³⁹ cl 80(1)(c).

¹⁴⁰ Explanatory Paper on Second Exposure Draft of Futures Industry Bill 1985, October 1985, para 246. The SFE Submission on the First Exposure Draft argued that a suitability requirement "could be seen by the prospective client to be an invasion of its privacy. Moreover, it might be impossible in practice for a broker to do his best for the client by executing his instructions urgently and to still find time to make the prescribed inquiries": para 6.2.

¹⁴¹ By-Law G.32(a)(iii). This provides that a member shall not operate a Managed Discretionary Account unless:

"the member has reasonable grounds for believing that the Managed Discretionary Account is suitable for the client, having regard to the facts known, *or which ought reasonably to be known*, about the Managed Discretionary Account, the client's other investments and his personal and financial situation".

This suitability requirement was introduced at the direction of the ASC "to limit discretionary trading to those individuals who can afford the risks involved in this form of trading activity": see Report on the Public Hearing on Discretionary Futures Accounts [1991] *ASC Digest* Volume 2, Public Hearing 12, para 73(f).

¹⁴² s 851. Civil liability for breach of s 851 is set out in s 852.

A securities adviser¹⁴³ who makes a securities recommendation to a person who may reasonably be expected to rely on it must have a reasonable basis for making the recommendation. The adviser lacks a reasonable basis unless the adviser has based the recommendation on reasonable consideration and investigation of its subject matter, carried out in the light of known relevant information about the person.

Consideration and investigation of recommendations. An adviser must ensure that any reliance on external research and analysis is reasonable in the circumstances.¹⁴⁴ Also, an adviser should consider economic and accounting information relating to markets, industries and securities in assessing the future income, growth expectations and risk factors associated with recommended securities.¹⁴⁵

ASC Practice Note 41 supports clients being given written reports about securities recommendations. In its view, these reports should deal with risk factors and return expectations including:

- (a) risks associated with the issuer. This includes the qualities and experience of the issuer, associated companies, management company and trustee, as appropriate;
- (b) risks associated with the product, such as the quality of underlying assets and risk-return characteristics of the product;
- (c) market and economic risks, such as economic cycles, volatility and other capital market factors; and
- (d) capital and income prospects.¹⁴⁶

Advice may be limited to a particular element of a proposed investment portfolio if the client has only requested this limited advice or the client's circumstances make it clear to the adviser that only limited advice is necessary.¹⁴⁷

¹⁴³ A securities adviser is a dealer, an investment adviser or a securities representative of either: s 9. A dealer is a person who carries on a securities business and an investment adviser is a person who carries on an investment advice business. "Securities business" is defined in s 93, "investment advice business" in s 77 and "securities representative" in s 94.

¹⁴⁴ ASC Practice Note 41, para 16.

¹⁴⁵ Id, para 17.

¹⁴⁶ Id, para 19.

¹⁴⁷ Id, para 27.

If advice is limited to particular securities within the scope of any licence restriction, "the adviser should also ensure that the client fully understands the limited nature of the advice provided and give written confirmation of the limited nature of the advice provided".¹⁴⁸ If none of the adviser's products is suitable, the adviser should either recommend "no investment" or refer the client to another adviser.¹⁴⁹ Similarly, if the adviser considers the client's needs would be best served by investment in a wider group of securities than the adviser can advise on under the licence, the adviser should disclose this to the client and recommend the client seek advice from a suitably licensed adviser.¹⁵⁰

Information about the client. A securities adviser does not have a positive obligation to obtain information about the client's investment objectives, financial situation and particular needs.¹⁵¹ Nevertheless, ASC Practice Note 41 states that an adviser has an obligation to obtain certain information "in order to satisfy the duty of care and any fiduciary obligation owed by the adviser to a client at general law where it is not already implied by s 851(2)(a)".¹⁵² The information which it considers should be known to the adviser before making a recommendation is:

- (a) details of the client's need for income, capital growth, security, liquidity, and flexibility to convert investments to cash as well as the time period the client is planning for;
- (b) the client's personal circumstances and individual values and aversion or tolerance to risk;
- (c) details of substantial assets owned alone, jointly or in common with another person by the client;
- (d) details of liabilities and potential liabilities of the client;
- (e) current expenditure and income and an indication of future income and expenses, as well as capacity to save, and tax status of the client;

¹⁴⁸ Id, para 28.

¹⁴⁹ Id, para 29.

¹⁵⁰ Id, para 30.

¹⁵¹ In particular, s 851(2)(a) refers to the information which the securities adviser "has" about those matters, not information that the adviser "should reasonably have". See the discussion in ALRC/CASAC Report on Collective Investments (1993), vol 1, para 13.8; R Baxt, HAJ Ford and AJ Black, *Securities Industry Law* (4th ed, Butterworths, 1993) para 907 and J O'Sullivan, "Regulation of Securities Intermediaries in Australia" in Walker & Fisse, *supra* note 3, 476 at 493.

¹⁵² para 24.

- (f) existing asset and income protection held by the client;
- (g) the level and type of superannuation cover of the client; and
- (h) other client details such as their age, family commitments and social security eligibility.¹⁵³

Also, according to the Practice Note, the adviser should "reassess the client's circumstances periodically to ensure that this information is current and comprehensive".¹⁵⁴

The Practice Note states that an adviser should consider whether or not any recommendation can be made "taking into account the general law obligations" if a person is unwilling to give the adviser information which the adviser considers necessary to form the basis of a recommendation.¹⁵⁵ It also states that the general law duty would require an adviser to advise a person that non-disclosure prevents the adviser from giving appropriate advice.¹⁵⁶

Record keeping. There is no record keeping requirement in either s 851 or s 852. However, Practice Note 41 states that advisers should keep written records of information regarding the making of recommendations, including:

- (a) information obtained and relied on in assessing clients' situations....
- (b) reasons why certain securities were considered appropriate for a particular client including key features of the products recommended, how those features apply to the client's specific needs and the source of product information; and
- (c) details of any oral recommendations made.

The ASC will test the practices adopted by a licensee against those in Practice Note 41 in examining a licensee's advising conduct.¹⁵⁷

Liability for breach of suitability requirement. A securities adviser is liable to compensate a client for any loss suffered from the making of a securities recommendation without a reasonable basis.¹⁵⁸ It is a defence if the recommendation was appropriate in all the circumstances having regard to the

¹⁵³ para 23.

¹⁵⁴ para 22.

¹⁵⁵ para 25.

¹⁵⁶ para 26.

¹⁵⁷ para 39.

¹⁵⁸ s 852.

information that the securities adviser had about the client's investment

objectives, financial situation and particular needs at the time of making the recommendation.¹⁵⁹

ASX Options Market rules

The ASX Business Rules impose two suitability requirements relating to option contracts traded on the AOM.¹⁶⁰ The first relates to *recommending* a transaction for taking or writing any type of option traded on the ASX. The second relates to *effecting* a transaction under which a person assumes an obligation as the writer of a call option over underlying securities where the person does not own the underlying securities (an "uncovered call option").

Recommending an options transaction

The Rules provide:

"No Clearing Member, officer or employee thereof shall recommend to any client any transaction for the taking or writing of an Option unless such Clearing Member, officer or employee has reasonable grounds to believe that the entire recommended transaction is not unsuitable for such client on the basis of information furnished by such client after reasonable inquiry concerning the client's investment objectives, financial situation and needs, and any other information known by such Clearing Member, officer or employee."¹⁶¹

This contrasts with s 851 in referring to:

- "not unsuitable" (as opposed to "reasonable basis for making a recommendation" and "appropriate" in s 851)
- "reasonable inquiry" (no equivalent in s 851).

Writing a call option

There are additional obligations on a clearing member and its officers and employees where, broadly speaking, it is proposed that a client write an uncovered call option on underlying securities which are capable of delivery. Such a transaction may not be effected:

¹⁵⁹ s 852(4).

¹⁶⁰ ASX Business Rules Section 7.

¹⁶¹ r 7.1.19(a).

"unless, on the basis of information obtained by such Clearing Member, officer or employee from such client after reasonable inquiry, and any other information known by such Clearing Member, officer or employee, such Clearing Member, officer or employee has a reasonable basis for believing that the client at the time of the transaction, is capable of evaluating the additional risks in such transactions and has the financial capability to meet reasonable foreseeable margin calls, pursuant to applicable margin requirements with respect to the proposed position in such Call Option".¹⁶²

The corresponding rule for index call options requires the same reasonable belief as to the ability to evaluate additional financial risks and financial capability to meet margin calls.¹⁶³

Warrants

There are specific suitability requirements for warrants in the ASX Business Rules.¹⁶⁴

General law duties

A securities or futures adviser owes a common law duty of care to a client. Similarly, any adviser who gives advice in the course of a fiduciary relationship has a fiduciary duty of care commensurate with that relationship. Where the relationship between the adviser and client is contractual, a term may be implied that the adviser will use the skill and diligence which a reasonably competent and careful adviser would exercise. Some commentators consider that a securities adviser may have a general duty to

¹⁶² r 7.1.19(b).

¹⁶³ r 7.2.15.

¹⁶⁴ Under r 8.14.2:

"No Member Organisation, officer or employee thereof shall recommend subscription or purchase of Warrants to any client unless such Member Organisation, officer or employee has reasonable grounds to believe that the entire recommended transaction is not unsuitable for such client on the basis of information furnished by such client after reasonable inquiry concerning the client's investment objectives, financial situation and needs, and any other information known by such Member organisation, officer or employee. In assessing the suitability of such transactions an advisor is entitled to rely on representations made by the client."

The last sentence of the rule does not appear in any of the other Australian suitability requirements considered.

enquire about a client's financial situation and investment objectives.¹⁶⁵ It is unclear whether such an obligation would be applied by analogy to a futures broker.¹⁶⁶

A futures broker appears to have a duty to explain the operation of margin calls, at least where the broker is dealing with a person who is unfamiliar with such transactions.¹⁶⁷ There may be a corresponding duty to enquire about the client's knowledge of the markets.¹⁶⁸ There may also be a duty to explain to inexperienced clients "certain other critical or complex aspects of the markets' operation or of the broker's business practices which are peculiar to futures dealings or which impose substantial risks".¹⁶⁹

A futures broker is under no fiduciary obligation to give advice to a client. However, a broker who gives advice must do so "honestly and with appropriate skill and ability".¹⁷⁰ Also, a broker has a duty not to make "negligent misstatements" in the giving of any advice.¹⁷¹ However, none of these common law duties specifically impose an obligation on the broker to first ascertain details about the client and to ensure the suitability of any transaction recommended.

Proposed reform of statutory requirement

The ALRC/CASAC Collective Investments Report 1993 recommended that the Corporations Law should make it clear that the "know your client" obligation requires an adviser to make reasonable inquiries about, and other reasonable investigations of, the client's investment objectives, financial situation and needs and base any recommendations on the results of those inquiries and investigations.¹⁷²

¹⁶⁵ See Baxt, Ford and Black, *supra* note 151 at para 907. This is also the view taken by the ASC in Policy Statement 41.

¹⁶⁶ See, for example, the discussion in Currie, *supra* note 58 at 120 and Hains, "Duties and Obligations of a Futures Broker to his Client" (1987) 3 *Australian Bar Review* 122.

¹⁶⁷ *Rest-Ezi Furniture Pty Ltd v Ace Shohin (Australia) Pty Ltd* (1986) 5 ACLC 10, discussed in Currie, *supra* note 58 at 120 and Hains, *supra* note 80.

¹⁶⁸ Currie, *supra* note 58 at 120.

¹⁶⁹ *Id* at 121.

¹⁷⁰ *Option Investments (Aust) Pty Ltd v Martin* (1980) 5 ACLR 124 at 128.

¹⁷¹ *Hedley Byrne v Heller* [1964] AC 465.

¹⁷² *Collective Investments: Other People's Money* (1993), Report No 65 para 13.10.

The ASC OTC Derivatives Report 1994 recommended that the derivatives law reform review should consider:

- whether licensed intermediaries in derivatives markets should be subject to a suitability requirement analogous to that applying to securities dealers and
- what limits, if any, there should be to the application of such a requirement.¹⁷³

The Report also suggested that a suitability requirement be introduced for derivatives. Such a requirement might involve requiring a licensed dealer to:

- demonstrate that the particular derivatives transaction will not expose the retail participant to increased risk of financial loss or
- be satisfied on reasonable grounds that the retail participant has sufficient experience and understanding to appreciate the risks involved in the transaction.¹⁷⁴

Licensing

Chapters 7 and 8 deal with the issue, revocation and variation of licences, the imposition of licence conditions, agreements with unlicensed persons, representatives and their liability, and exclusion from the futures and securities industry. The main differences between the Chapters are discussed below.

Licence applications

To be a futures licensee it is necessary to be a member of a futures organisation.¹⁷⁵ There is no similar statutory requirement for securities licensees, although the ASC may impose a condition that the applicant be a member of a self-regulatory securities organisation. The eligibility requirements are otherwise substantially similar for licensees under both Chapters.

¹⁷³ recommendation 12.

¹⁷⁴ paras 256-257.

¹⁷⁵ ss 1144A(2)(c), 1145(2)(d), s 1148(1)(a).

Licensing requirements

The tests differ for who should be licensed under Chapters 7 and 8. A securities dealers licence will only be required where a dealer is in the business of dealing in securities¹⁷⁶ whilst a futures brokers licence is required for every dealing on behalf of other persons.¹⁷⁷ Those who only trade in futures contracts as a principal, or only on behalf of related companies, and who give no advice concerning futures contracts, need not be licensed as either futures brokers or futures advisers.¹⁷⁸

Persons who advise on futures or securities must hold a futures advisers licence or an investment advisers licence unless they already hold a futures brokers licence or a dealers licence respectively.¹⁷⁹ The ASC OTC Derivatives Report 1994 noted uncertainty about whether futures advisers licensing provisions apply to the normal course of dealings between the operator of an exempt futures market and its clients.¹⁸⁰ An exempt futures market operator giving futures advice to persons with whom the operator deals as principal could be regarded as conducting a business of advising the persons about futures contracts, for which a futures advisers licence would be required.¹⁸¹

The ASC OTC Derivatives Report 1994 noted a range of views on whether the providers of OTC derivatives facilities should be licensed. Possible options were:

¹⁷⁶ s 780. A securities business is broadly defined in s 93(1) as "a business of dealing in securities". "Deal", in relation to securities, is broadly defined in s 9 and includes inducing or attempting to induce a person to make or offer to make an agreement in relation to acquiring, disposing of, subscribing for or underwriting securities. The term "business" is not defined in the Corporations Law.

¹⁷⁷ Licensing as a futures broker is required if a person deals in futures contracts "on behalf of another" or holds out that the person carries on a futures broking business: s 1142. "Futures broking business" is defined in s 9 as a business of dealing in futures contracts on behalf of other persons. The definitions of "on behalf of" in s 9 and Pt 1.2 Div 4 of the Corporations Law give an extended meaning to the concept of dealing "on behalf of" others in futures contracts. The requirement for persons dealing on behalf of others to be licensed as futures brokers was to prohibit "bucketing", where client orders are not placed for execution on the relevant futures market. Rather the intermediary either takes the other side of the transaction or matches it with equal and opposite orders from other clients. The effect of this is that the clients do not obtain the benefits of clearing house arrangements.

¹⁷⁸ O'Sullivan, *supra* note 58 at 97.

¹⁷⁹ ss 1143, 781.

¹⁸⁰ paras 114-116.

¹⁸¹ s 1143; s 71 defines what is meant by "futures advice business".

- they should not be required to be licensed
- they should be required to hold a futures brokers licence
- they should be subject to licensing requirements equivalent to those for securities dealers or
- they should not have to be a member of a futures organisation such as the Sydney Futures Exchange to obtain a futures brokers licence.¹⁸²

The ASC noted that there is no separate licensing provision for "OTC market makers" (dealers who regularly quote both bids and offers and are ready to make a two-sided OTC market). It recommended that, as a general principle, all OTC intermediaries, that is brokers, market makers and advisers, should be licensed.¹⁸³

Licence conditions

The ASC, by imposing conditions, can restrict the class of investment in which a futures or securities licensee can deal or advise.¹⁸⁴

The provisions regulating the conditions applicable to futures and securities licences are substantially similar except that securities licensees, but not futures licensees, must lodge and maintain with the ASC an approved security.¹⁸⁵

Civil liability for breach of licensing requirements

Unless exempt, unlicensed persons may not:

- carry on a futures or securities business¹⁸⁶ or a futures or investment advice business or
- hold out that they carry on such a business.

¹⁸² para 117.

¹⁸³ para 245-247, recommendation 9.

¹⁸⁴ The ASC's powers to impose conditions are in ss 786(1)(b) and 1147(b). The ASC may require that a securities dealer comply with standards in the ASX business rules as a condition for trading certain types of securities. The business rules can cover such matters as level of expertise, probity, financial backing and capital adequacy, and trading procedures. The Minister may disallow amendments to the ASX or SFE business rules: ss 774(5), 1136(5).

¹⁸⁵ s 786(2)(d), (9).

¹⁸⁶ In the case of futures, the reference is to dealing in futures contracts: s 1142(a).

Civil liability for breach¹⁸⁷ is substantially similar for futures and securities except that there is no liability on persons who merely hold themselves out to be carrying on a futures broking business.¹⁸⁸ This may be a technical oversight.

Advertising

The ASC may prohibit a person from publishing or broadcasting statements concerning futures contracts or futures broking or advising businesses.¹⁸⁹ There is no equivalent securities provision. However, there are restrictions on advertising securities subject to a prospectus.¹⁹⁰

Protection of client money

A securities dealer must maintain a trust account, and a futures broker a clients' segregated account, for clients' money.¹⁹¹ Securities dealers, but not futures brokers, must ensure that the funds of a particular client are in credit before making payments on that client's behalf in relation to a transaction.¹⁹² The exemption for futures brokers is necessary given the way the futures clearing house operates.¹⁹³

Compensation funds

Customers of ASX securities dealers are compensated from the National Guarantee Fund (NGF) administered by the Securities Exchange Guarantee Corporation (SEGC). The ASX is not also required to maintain a fidelity fund.¹⁹⁴ The NGF covers a wide range of claims for compensation including:

¹⁸⁷ Pt 7.3 Div 2 (ss 794-805), Pt 8.3 Div 2 (ss 1159-1171).

¹⁸⁸ s 1160; cf ss 795(3), 1161.

¹⁸⁹ s 1205.

¹⁹⁰ ss 1025, 1026.

¹⁹¹ ss 866 (trust account), 1209 (clients' segregated account).

¹⁹² Futures brokers are permitted to make withdrawals from a clients' segregated account to make a payment "for, or in connection with, the entering into, margining, guaranteeing, securing, transferring, adjusting or settling of dealings in futures contracts effected by the broker on behalf of clients only": s 1209(5)(b).

¹⁹³ It is not possible to identify funds paid by the floor member to the clearing house in response to deposit and margin calls as being received from a particular client: Explanatory Memorandum to the Futures Industry Bill 1986, para 200.

¹⁹⁴ The ASX, as a "participating exchange" (defined in s 761 as "an eligible exchange that is a member of SEGC"), is not required to keep a fidelity fund: s 895(1).

- claims between dealers and by clients against dealers for failure to perform an agreement for the sale or purchase of quoted securities¹⁹⁵
- claims for loss arising from an unauthorised transfer of quoted securities¹⁹⁶
- claims against insolvent dealers in connection with their dealing in quoted securities.¹⁹⁷

A claim does not depend on proof of defalcation or fraud by a dealer. The compensation may be either money or securities.

The SFE must maintain a fidelity fund¹⁹⁸ to compensate customers of a futures broker for loss resulting from the broker's defalcation or fraudulent misuse of money or property in connection with dealings in futures contracts.¹⁹⁹ In addition, the SFE has a discretion to compensate for losses arising from the broker's insolvency.²⁰⁰

Offences

The securities and futures offence provisions deal with insider trading and other forms of market manipulation.²⁰¹ The futures provisions were modelled on the securities provisions and are similar. Two significant differences are:

- the securities, but not the futures, insider trading provisions were reformulated in 1991²⁰²

¹⁹⁵ ss 949-952 (Division 6).

¹⁹⁶ Division 7.

¹⁹⁷ Division 8. The claim may not exceed 14% of the minimum amount of the NGF: s 968(1). The minimum amount is A\$15,000,000 or another amount determined under s 936 (definition of "minimum amount" in s 920).

Other claims that may be made against the NGF relate to securities loans (Division 6A), net obligations (Division 6B), ineffective FAST transfers (Division 6C) and loss arising from cancellation of shares certificates under CHES, except for losses that arise from unauthorised transfers, which must be dealt with under Division 7 (Division 7A).

¹⁹⁸ s 1228.

¹⁹⁹ s 1239(1).

²⁰⁰ s 1239(3), (4), (5).

²⁰¹ Pts 7.11, 8.7.

²⁰² Contrast Pt 7.11 Div 2A with Pt 8.7 Div 1.

- there is an offence of improper trading on a physical market to manipulate the futures market.²⁰³

²⁰³ s 1259. This reflects the inter-relationship and inter-dependence of the derivative and physical markets. Cf s 997.

Gaming and wagering legislation

The laws prohibiting gaming and wagering are not applicable to certain futures and options contracts traded on-exchange or on an exempt market or to futures contracts otherwise permitted by the rules of a futures association or exchange.²⁰⁴ This protection does not apply to other derivatives.

Australian review of derivatives

ASC OTC Derivatives Report

The 1994 Report and ASC Policy Statement 70 outlined the basis of the Commission's revised policy on applications for exempt futures market declarations pursuant to s 1127(1). The Report also:

- sought to develop the revised policy as part of the treatment of OTC derivatives under the Corporations Law and
- made suggestions on the general direction of future law reform in the regulation of derivatives.

Regulatory proposal

The Report identified its key concerns as:

- legal uncertainty about the regulation of derivatives under Chapter 7 and Chapter 8 of the Corporations Law
- different regulatory regimes for products with similar characteristics
- the protection of "retail" customers
- the need to ensure orderly markets and reduce systemic risk
- differences between the treatment of on-exchange and OTC derivatives, even where these transactions involve sophisticated participants and
- the application of the Corporations Law licensing provisions to OTC dealings.²⁰⁵

²⁰⁴ s 778, s 1141.

²⁰⁵ para 7.

The ASC proposed three tiers of market regulation by reference to different market participants and types of transactions.

- The first tier would involve sophisticated participants entering into individually negotiated non-tradeable transactions. The ASC would advise the Minister that an exempt futures market declaration should be made for these transactions.²⁰⁶ This is reflected in ASC Policy Statement 70.
- The second tier would involve freely tradeable transactions between sophisticated (wholesale) participants. The Report considered that the element of unrestricted trade raised issues relating to the fair and orderly conduct of an organised market even where all the participants were sophisticated. It recommended that this activity be subjected to greater regulation than in the first tier.
- The third tier would relate to transactions involving unsophisticated (retail) investors. The Report considered that such transactions should be subject to full individual investor protection regulation.

Law reform issues

The Report identified two principal themes for law reform:

- identifying and defining the scope of regulation, in particular which activities should be defined and made subject to the Corporations Law as "regulated derivatives transactions"
- identifying the appropriate content of regulation for those transactions.²⁰⁷

ASC Policy Statement 70

ASC Policy Statement 70 (November 1993) was developed on the basis of a draft version of the ASC Report released for public comment in July 1993. Its purpose is to establish an interim "safe harbour" to permit certain futures market activities to take place with minimum regulation, pending a comprehensive review of derivatives regulation. The Policy Statement is consistent with the Report's view that there should be three tiers of derivatives regulation. The safe harbour is designed to regulate the first tier (individually negotiated non-tradeable transactions between sophisticated participants). The

²⁰⁶ Pt 8.7 (market manipulation and other offences) will still apply to these transactions.

²⁰⁷ Section 6.

Policy Statement does not deal with applications in relation to second tier (sophisticated participants dealing in tradeable derivatives) or third tier (non-sophisticated participants) transactions.

It details the criteria which the participants and the transactions must meet to come within the first tier.

Participants

The policy statement states that providers of derivatives market facilities must be subject to prudential regulation which ensures minimum capital standards that are monitored through regular reporting obligations. The users of these derivatives must be sophisticated persons.

Transactions

First tier transactions must be individually negotiated and must not be tradeable. The transactions must be between permitted participants and must not be supported by the credit of a clearing house or a mark-to-market margin and settlement system involving a third party.

The ASC has also indicated that it will not enforce Chapter 8 in relation to certain intra-group transactions. The Policy Statement provides that this exemption will remain in force until the issue has been examined in detail as part of the proposed law reform review.

The Policy Statement does not specify regulation for second or third tier transactions. However, it notes the ASC's concerns in these areas, particularly in relation to investor protection and fair and efficient markets.

CHAPTER 3. UNITED KINGDOM

Scope of regulation

Regulatory overview

The United Kingdom system of derivatives regulation is largely self-regulatory. The Financial Services Act 1986 provides for a multi-tiered system of regulation under which the Department of Trade and Industry has delegated many specified regulatory powers to a private sector Designated Agency,²⁰⁸ the Securities and Investments Board (SIB). The SIB, in turn, has authorised a number of self-regulatory organisations (SROs) that make and enforce rules concerning their respective members' activities in the financial services industry.

SROs recognised by the SIB include the:

- Securities and Futures Authority (SFA)
- Investment Management Regulatory Organisation (IMRO)
- Financial Intermediaries, Managers and Brokers Regulatory Association (FIMBRA)
- Life Assurance and Unit Trust Regulatory Organisation (LAUTRO).

A new "retail" self-regulatory organisation, the Personal Investment Authority, has been established to replace LAUTRO and FIMBRA and regulate some members of IMRO.

Broadly speaking, any person who carries on investment business in the UK must be authorised²⁰⁹ unless exempted.²¹⁰ Authorisation may be obtained:

- directly from the SIB²¹¹

²⁰⁸ The Department may delegate certain powers to a Designated Agency (Financial Services Act s 114(1)) where it is satisfied that the rules and regulations of the body afford investors an "adequate level of protection": s 114(9).

²⁰⁹ Persons who have received authorisation are referred to in this Paper as "authorised persons".

²¹⁰ For instance, the Bank of England, recognised investment exchanges and clearing houses, Lloyd's, certain money market organisations and appointed representatives have been exempted.

- by membership of an SRO²¹² or
- by certification by a recognised professional body such as the Law Society or the Institute of Chartered Accountants.²¹³

Certain persons such as authorised insurance companies are automatically authorised.²¹⁴

Role of SROs

Function of SROs

The SFA regulates:

- those dealing in and those arranging, and advising on, dealings in all types of investments, including futures, options and contracts for differences
- managers of assets some or all of which are derivative instruments, unless the investments managed are primarily securities
- managers or operators of authorised unit trusts and recognised collective investment schemes which are dedicated to derivatives, for example, futures and options funds.

The SFA is primarily responsible for regulating derivatives activities, though the other SROs also have a limited role.²¹⁵ IMRO regulates derivatives transactions that are ancillary or incidental to an investment management or advisory business. FIMBRA regulates options on securities and equity indices traded on or under the rules of a recognised or designated investment exchange²¹⁶ and used only for hedging. LAUTRO regulates the marketing of authorised unit trust schemes which invest in futures and options.

²¹¹ Financial Services Act s 25.

²¹² Financial Services Act s 7.

²¹³ Financial Services Act s 15.

²¹⁴ Other examples are registered friendly societies, operators and trustees of recognised collective investment schemes and, subject to certain conditions, persons already authorised in European Union member states.

²¹⁵ Unless otherwise stated, all references to rules are to the SFA Rules.

²¹⁶ Investment exchanges that carry on an investment business in the UK must be recognised. To do so, they must satisfy certain Financial Services Act requirements. The SIB issued a guidance note in April 1993 requiring derivatives exchanges to "limit dealings on the exchange to investments in which there is a proper market". A recognised investment exchange is an exempted person in relation to investment

The SFA is controlled by a Board the majority of whose members are from the investment business firms which it authorises. The SFA:

- administers its rules through monitoring, inspection and investigation
- deals with complaints from the public
- authorises persons to carry on investment business.

Rules of SROs

The SIB issues Statements of Principle (Principles) and designates rules (Core Rules) to apply to all members of SROs (but not recognised professional bodies). The Principles are statements of the standards expected for any type of investment business done by any person. The Core Rules cover conduct of business, financial resources, client money and unsolicited calls. An SRO may derogate from the Core Rules in certain circumstances with SIB permission. The SRO rules explain, extend or qualify the Core Rules as appropriate for the particular investments supervised by the relevant SRO. Exchange and clearing house rules may also apply to SRO members.

SRO rules must, taken together with the Principles and Core Rules, provide adequate investor protection. In determining this, regard must be had to the nature of the investment business carried on by the SRO members, the kinds of investors involved (for example, sophisticated investors), compliance costs and the effectiveness of the SRO's enforcement arrangements. The rules cover:

- conduct of business
- financial and transaction reporting
- capital adequacy
- segregation of client money and
- custody of client assets.

business and does not require authorisation. Some overseas investment exchanges are recognised, including the Sydney Futures Exchange. Designated investment exchanges are overseas exchanges which do not carry on investment business in the UK and which are considered by the SIB to provide investor protection comparable to that of recognised investment exchanges. Transactions on these exchanges are treated as if they had occurred on a recognised exchange.

Regulated investments

Any person dealing in, arranging dealings in, managing or advising on "investments" in the UK is carrying on "investment business"²¹⁷ and must be either authorised or exempted under the Act.²¹⁸ "Investment" is exhaustively defined by reference to a schedule which includes investments such as shares, debentures, government securities, units in collective investment schemes and long term insurance contracts.²¹⁹ It also includes:

- . options
- . futures
- . contracts for differences
- . rights and interests in investments.

A derivative will thus be regulated as an "investment" if it is an option, future or contract for differences or it falls within one of the other categories of "investment", irrespective of whether it is on-exchange or OTC.

Options

This comprises an option to acquire or dispose of:

- . one of the other types of "investment"
- . currency
- . gold, palladium, platinum or silver
- . an option to acquire or dispose of one of the above three items.²²⁰

²¹⁷ Financial Services Act s 1(2); Sch 1, Pt II.

²¹⁸ Financial Services Act ss 3, 4. There are various exclusions from this requirement including one which applies to options, futures, contracts for differences, rights and interests in investments where:

- . the transaction is or is to be entered into by a person as principal and
- . that person is not an authorised person and
- . the transaction is or is to be entered into by the person (a) with or through an authorised, exempted or permitted person or (b) through an office outside the UK maintained by a party to the transaction and with or through a person whose head office is situated outside the UK and whose ordinary business involves investment business activities (Financial Services Act Sch 1 para 17(4)).

²¹⁹ Financial Services Act Sch 1 Pt I.

²²⁰ Financial Services Act Sch 1 para 7.

A cash-settled option, such as a stock index option, will be a contract for differences, not an option to acquire or dispose of an investment.

Futures

There is a very broad definition of futures:

"Rights under a contract for the sale of a commodity or property of any other description under which delivery is to be made at a future date and at a price agreed upon when the contract is made."²²¹

There are various exceptions to the definition. Contracts made for "investment purposes" are regulated, whereas those made for "commercial purposes" are exempt.²²² A contract is made for investment purposes where "it is made or traded on a recognised investment exchange or made otherwise than on a recognised investment exchange but expressed to be as traded on such an exchange or on the same terms as those on which an equivalent contract would be made on such an exchange".²²³ A contract which does not meet these requirements and provides for delivery within seven days is regarded as being made for commercial purposes and therefore not regulated as a futures contract.²²⁴

The following are indications that the contract is made for investment purposes.

- . It is expressed to be as traded on a market or on an exchange.
- . Its performance is ensured by an investment exchange or a clearing house.
- . There are arrangements for payment or provision of margin.²²⁵

²²¹ Financial Services Act Sch 1 para 8.

²²² Note 1 to the definition of futures. It is possible that a contract made for commercial purposes may still be regulated as an "investment" if it falls within the definition of "contract for differences". Where other futures and forward contracts are concerned, SIB guidance published in March 1988 says that an insignificant investment purpose will not bring a commercial contract within the Financial Services Act: TB Little, "Derivatives: The UK Regulatory Jumble" (1994) Vol 1 No 2 *The Futures and Derivatives Law Review* 13 at 17.

²²³ Note 2 to the definition of futures.

²²⁴ Note 3.

²²⁵ Note 6.

The following are indications that the contract is made for commercial purposes.

- Either or each of the parties is a producer of the commodity or other property or uses it in its business.
- The seller delivers or intends to deliver the property or the purchaser takes or intends to take delivery of it.²²⁶

The absence of either of them is an indication that it is made for investment purposes.

It is also an indication that a contract is made for commercial purposes that its terms are determined by the parties for the purpose of the particular contract, not by reference to regularly published prices, standard lots or delivery dates or standard terms.²²⁷

Contracts for differences

These are defined as contracts:

"... the purpose or pretended purpose of which is to secure a profit or avoid a loss by reference to fluctuations in the value or price of property of any description or in an index or other factor designated for that purpose in the contract."²²⁸

The definition does not apply where the parties intend that the profit or loss will arise by taking delivery of property under the contract.²²⁹ A contract stated to require delivery may nevertheless be a contract for differences if the parties do not in fact intend that delivery occur. There is no commercial purposes exception for contracts for differences. Swaps fall within this category.

Collective investments

²²⁶ Note 4.

²²⁷ Note 5.

²²⁸ Financial Services Act Sch 1 para 9.

²²⁹ Note 1 to the definition of contracts for differences.

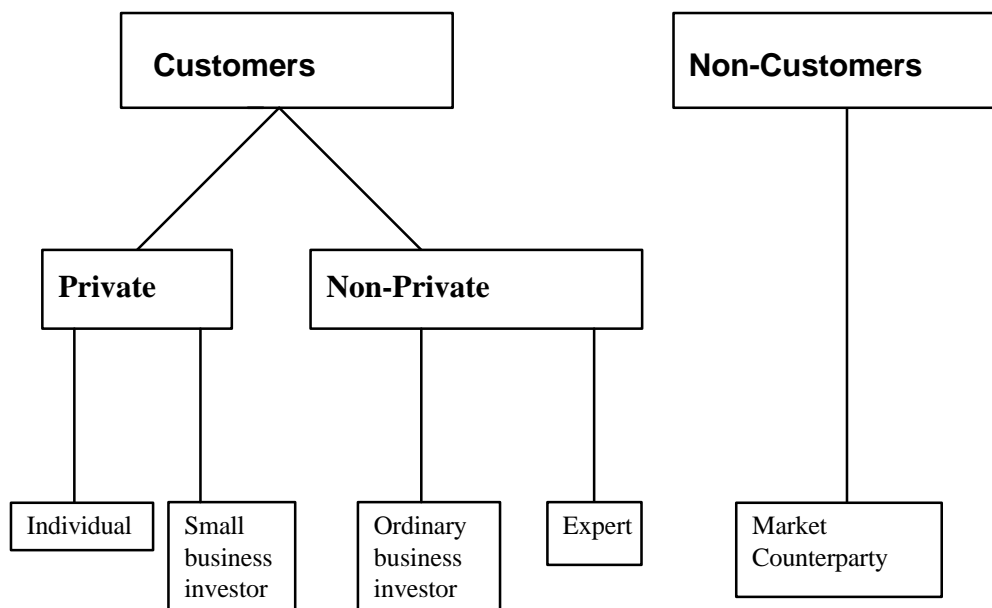
Some derivatives, for example basket warrants, may be collective investment schemes, defined widely under the Financial Services Act.²³⁰ If so, there are

²³⁰ s 75.

special marketing restrictions and the person marketing the derivatives must be authorised. There is no general exclusion of futures, options or contracts for differences from the definition of collective investment schemes.²³¹

Customers and non-customers

The SIB Core Conduct of Business Rules and the SFA rules distinguish between customers and non-customers. A further distinction is made between private and non-private customers. There are several sub-categories, outlined in the diagram below. The classification of a client is highly significant as it affects the extent of a firm's obligations.²³² The greatest obligations are owed to private customers, the least to non-customers.²³³



²³¹ Little, supra note 222 at 18.

²³² See summary infra at 88-89. "Firm" here refers to an authorised person whether an individual, partnership or corporation.

²³³ Thus, for example, out of the 40 SIB Core Conduct of Business Rules, 9 apply where a firm is not dealing with customers, 31 apply where a firm is dealing with customers and of these, 15 apply where the customer is a non-private customer: JRC White, *Regulation of Securities and Futures Dealing* (Sweet and Maxwell, 1992) at 87.

Customers

A customer is any person with or for whom the firm carries on, or intends to carry on, any regulated or associated business.²³⁴ This term includes a potential customer, an indirect customer and a customer of the firm's appointed representative, but does not include a market counterparty or a trust beneficiary.²³⁵

Private customers

Individual. An individual (that is, a natural person) is a private customer unless the person is acting in the course of carrying on investment business or qualifies as an expert investor.²³⁶

Small business investor. A non-individual is a private customer if it is not acting in the course of carrying on investment business and is a small business investor.²³⁷ A small business investor is:

- a company which has (together with its holding companies or subsidiaries) a called up share capital or net assets of less than £5 million (less than £500,000 if the company or any holding company has more than 20 members)
- a partnership or unincorporated association with net assets of less than £5 million
- a trust which has, or at any time during the previous two years had, assets in cash and investments (before deducting liabilities) of less than £10 million.²³⁸

However, a small business investor customer will be treated as a non-private customer if the firm reasonably believes that the customer is an ordinary business investor²³⁹ or expert.²⁴⁰

²³⁴ r 9-1 definition of "customer".

²³⁵ Ibid. The term "indirect customer" is discussed infra at 68.

²³⁶ r 9-1 definition of "private customer"; r 5-5(1).

²³⁷ r 9-1 definition of "private customer".

²³⁸ r 9-1 definitions of "small business investor" and "ordinary business investor".

²³⁹ r 9-1 definition of "private customer", paragraph (b).

²⁴⁰ r 5-5(1).

Non-private customers

A non-private customer is a customer who is not a private customer or who has consented to be treated as a non-private customer.²⁴¹ This category consists of ordinary business investors and experts.

Ordinary business investor. In broad terms, an ordinary business investor²⁴² is a customer who is reasonably believed to be:

- a government, local authority or public authority
- a company which has (or has a holding company or subsidiary which has) a called up share capital or net assets of £5 million or more (£500,000 or more if the company or any holding company has more than 20 members)
- a partnership or unincorporated association with net assets of £5 million or more
- a trustee of a trust which has, or at any time during the previous two years had, net assets of £10 million or more
- an authorised person,²⁴³ a listed money market institution or an overseas investment business.²⁴⁴

A firm may treat a company or partnership which otherwise would be a small business investor as an ordinary business investor if:

- the relevant transaction is an integral part of its main business
- the firm can show that it reasonably believes that the customer has sufficient experience and understanding to waive the protections provided for private customers
- the firm has sent a clear written warning of the protections the investor will lose, including a statement of the right to request to be treated as a private customer and

²⁴¹ r 9-1 definition of "non-private customer".

²⁴² r 9-1 definition of "ordinary business investor".

²⁴³ Supra note 209.

²⁴⁴ However, if an authorised person or overseas investment business is acting as agent for an identified principal, the firm must treat that principal as its indirect customer and hence although the agent will be treated as an ordinary business investor, the identified principal may be treated by the firm as a private customer: r 5-6 (see infra at 68).

- the customer has not informed the firm that it wishes to be treated as a private customer (either generally or in respect of the relevant transaction).²⁴⁵

Expert. A firm may treat a customer who would otherwise be a private customer as a non-private customer if:

- it can show that it reasonably believes that the customer has sufficient experience and understanding to waive private customer protections
- it has given the customer a clear written warning of the protections the customer will lose (for example, risk warnings, the suitability requirement, the prior disclosure of charges, the requirements for customer agreements)²⁴⁶ and
- the customer has given written consent after a proper opportunity to consider that warning.²⁴⁷

The assessment of experience and understanding must take into account:

- the kind of investments and investment services in which the firm will conduct business with or for the customer
- the customer's knowledge and understanding of the nature and risks of the relevant markets, investments and investment services
- the frequency and capacity of previous dealing by the customer
- the size and nature of the transactions
- the customer's financial standing.²⁴⁸

The SFA has said that a customer should not be treated as an expert in options or futures unless the customer is experienced in derivatives of the relevant kind, not just in other investments or types of derivative.²⁴⁹

²⁴⁵ r 5-5(4).

²⁴⁶ In addition, the warning should explain that the right to sue for damages for breach of private customer protections is lost and that the customer will not have access to the SFA's Consumer Arbitration Scheme: r 5-5, Guidance note 4.

²⁴⁷ r 5-5(1). Written consent is not required where the customer is ordinarily resident outside the United Kingdom and the firm reasonably believes that the customer consents, but does not want to do so in writing: r 5-5(2).

²⁴⁸ r 5-5, Guidance note 3.

²⁴⁹ SFA guidance, February 1994; Little, *supra* note 222 at 25.

Consent. A firm may treat a customer as a non-private customer if:

- the firm reasonably believes that the customer has sufficient experience and understanding to waive the protections provided for private customers
- the firm gives the customer a written warning of the protections which the customer will lose and
- the customer consents in writing after a proper opportunity to consider the warning.²⁵⁰

Indirect customers

All obligations owed to customers are also owed to indirect customers, unless expressly excluded.²⁵¹ "Indirect customer" means, where a customer is known to be acting as agent, an identified principal who would be a customer if dealt with directly.²⁵² Agreements in writing between the firm and the agent may vary this position.²⁵³

Non-customers

The principal category of non-customers is market counterparties.²⁵⁴ These are persons who deal with the firm:

- as principal, or as agent for an unidentified principal and
- in the course of investment business of the same description as the firm's.²⁵⁵

²⁵⁰ There is a model non-private customer notice (SFA Rules, Appendix 40, Sch 3). It sets out the protections lost such as:

- risk warnings - no obligation to warn of the nature of any risks involved in transactions recommended and no obligation to give written risk warnings for warrants and derivatives
- customer agreements - no obligation to set out in writing the basis on which services are provided (except in relation to discretionary customers)
- suitability - no obligation that recommendations be suitable (except for discretionary customers).

²⁵¹ r 9-1 definition of "customer", paragraph (a)(ii).

²⁵² r 9-1 definition of "indirect customer".

²⁵³ r 5-6.

²⁵⁴ r 9-1 definition of "customer", paragraph (b). Trust beneficiaries are also non-customers.

²⁵⁵ r 9-1, definition of "market counterparty".

Originally, whether a person was a market counterparty needed to be determined for each individual transaction. Problems arose from:

- the need to know the capacity in which the other person was dealing prior to entering into the transaction
- the interpretation of "unidentified principal" and "in the course of investment business of the same description".²⁵⁶

In response, the SFA extended the definition of market counterparty to permit particular classes of persons to be treated as market counterparties for categories of, rather than individual, transactions. Thus, a firm regulated by the SFA may treat as a market counterparty:

- any other firm regulated by the SFA in respect of any type of investment business
- a trading member of an investment exchange in respect of the kinds of investments traded on that exchange or any related derivatives
- an overseas person who regularly deals off-exchange in investments of that kind or any related derivatives
- an inter-dealer broker in respect of activities undertaken as an inter-dealer broker
- countries, central banks, international banking or financial institutions whose members are countries, listed money market institutions in respect of debt investments or money market investments.²⁵⁷

Under the extended definition, a market counterparty notice must be sent to the other person before the person can be treated as a market counterparty.²⁵⁸ The person may elect not to be treated as a market counterparty either generally or in respect of particular kinds of investments.²⁵⁹ In that case, the

²⁵⁶ Where the agent's principal is identified, the agent is not a market counterparty and is therefore a customer of the firm. The agent's principal becomes the firm's indirect customer unless there is an agreement between the firm and the agent to the contrary: r 5-6(1).

²⁵⁷ r 5-4(1). The extension to the definition of market counterparty applies even where a person acts as agent for an identified principal or does not act in the course of investment business of the same description as the firm.

²⁵⁸ r 5-4(2). There are some exceptions to this requirement. One of the more important is where the person is another firm regulated by the SFA and both are trading members of the same investment exchange: r 5-4(3).

²⁵⁹ r 5-4(2)(b).

firm must treat the person as a customer unless the person falls within the Core Rule definition of market counterparty.²⁶⁰ A firm which is regulated by the SFA and which itself has private customers should not allow itself to be treated as a market counterparty where it believes that it will not be able to fulfil the duties and obligations owed to its private customers under the rules.²⁶¹

Content of regulation

Exchange-trading requirement

There is no general requirement that derivatives transactions take place on-exchange. However, a firm is prohibited from effecting, arranging or recommending an off-exchange contingent liability transaction²⁶² to a private customer unless the firm reasonably believes that the purpose of the transaction is to hedge against currency risk.²⁶³

Collective investment schemes

The SIB Rules impose restrictions on investments in derivatives by collective investment schemes.²⁶⁴

A futures or options fund may only invest in derivatives if its exposure is covered by scheme property together with permitted borrowing of up to 10%.²⁶⁵ The derivatives must be traded, or dealt in, on an approved derivatives market and effected on or under its rules or must fall within a

²⁶⁰ Guidance note 1 to r 5-4.

²⁶¹ Guidance note 3 to r 5-4.

²⁶² A contingent liability transaction is defined in r 9-1 as a derivatives transaction (the term "derivatives" is defined, also in r 9-1, as options, futures and contracts for differences) where the customer will or may be liable to make further payments (other than charges, and whether or not secured by margin) on completion or prior closing out. Futures contracts and the uncovered writing of options are definitely caught within this definition. These transactions must be effected on or under the rules of a recognised or designated investment exchange, or be both matched and identified as matched with an on-exchange transaction (unless prohibited by the exchange's rules).

²⁶³ SFA r 5-44; IMRO Ch II r 3.13; SIB Core Rule 27.

²⁶⁴ Financial Services (Regulated Schemes) Regulations 1991 reg 5.21.

²⁶⁵ Financial Services (Regulated Schemes) Regulations 1991 regs 5.23, 5.25(3), 5.63(1).

restricted range of acceptable off-exchange options.²⁶⁶ The SIB published a proposal in October 1993 to allow futures and options funds to invest in off-exchange futures.

Licensing

Persons may be authorised to carry on investment business through membership of an SRO. The initial and continuing membership requirements are the equivalent of licensing provisions.

To become an SFA member, a firm must be a "fit and proper person", assessed on:

- financial integrity and reliability
- absence of convictions or civil liabilities
- competence (for example, qualifications of staff)
- good reputation and character
- efficiency, honesty and fairness.²⁶⁷

Any person who wishes to act as a director, partner, manager, representative or trader of a member firm must also be registered.²⁶⁸

In applying for SFA membership, a firm must submit a business profile which describes its anticipated investment business and associated activities. An SFA member firm may only conduct investment business that is within the SFA's jurisdiction and the firm's business profile, which must be kept current.²⁶⁹ A firm must receive the SFA's permission before it undertakes any new kind of investment business.²⁷⁰

²⁶⁶ Financial Services (Regulated Schemes) Regulations 1991 regs 5.07(2), 5.21.

²⁶⁷ r 2-2, Appendix 3.

²⁶⁸ r 2-24.

²⁶⁹ r 2-19(1), (2).

²⁷⁰ r 2-19(4)-(6).

Disclosure

Risk disclosure

Private customers must receive a general risk disclosure statement and specific warnings for trading in warrants and derivatives (options, futures and contracts for difference) and non-readily realisable investments.

There are also warning requirements where a firm proposes to treat a person other than as a private customer.²⁷¹

General risk disclosure obligation

This obligation only applies where a firm recommends a transaction to,²⁷² or acts as a discretionary manager for, a private customer. In either case, the firm must take reasonable steps to enable the private customer to understand the nature of the risks.²⁷³ This is an ongoing obligation which affects every transaction. However, in determining what reasonable steps must be taken, a firm may take into account the customer's current understanding and previous course of dealing.²⁷⁴ A firm may need to give additional warnings or explanations for warrants, derivatives and non-readily realisable investments.²⁷⁵

²⁷¹ A firm must give a customer whom it proposes to treat as a non-private customer a clear written warning of the regulatory protections that the customer will lose: r 5-5(1)(b) (experts) and r 5-5(4)(c) (trade customers). Similarly, in some circumstances, a firm must send a notice to a person whom it proposes to treat as a market counterparty which does not have the benefit of the customer protections (r 5-4(2)(a)) unless both firms are trading members of the same investment exchange (r 5-4(3)).

²⁷² White (supra note 233 at 151) notes that the risk disclosure obligation does not apply to general investment advice, only to recommendations of specific transactions. He also suggests that it does not apply to a recommendation not to enter into a transaction.

²⁷³ r 5-30(1).

²⁷⁴ White, supra note 233 at 151. For example, where a written risk warning notice has been given to the customer, but the firm only begins to enter into the transactions covered by the notice some time later, it may be necessary to draw the customer's attention to the relevant paragraphs of the notice at that later time: White at 155.

²⁷⁵ Guidance note to r 5-30.

Specific written warning

Specific written warnings must be given by a firm:

- . recommending a transaction to
- . arranging or executing a transaction (even if it has not recommended it) for, or
- . acting as discretionary manager of

a private customer.²⁷⁶

The firm must obtain a signed copy of the warning notice "in circumstances where the firm is satisfied that the customer has had a proper opportunity to consider its terms" and before recommending, arranging or executing the transaction.²⁷⁷

Derivatives Risk Warning Notice. This describes various types of derivatives and seeks to explain their risks. It outlines futures, options (distinguishing between buying and writing options) and contracts for differences. It also contains material concerning:

- . off-exchange transactions
- . foreign markets
- . contingent liability transactions
- . collateral
- . commissions
- . suspensions of trading
- . clearing house protections
- . insolvency.

²⁷⁶ The written warning need not be given for warrants in certain cases: r 5-30(4).

²⁷⁷ r 5-30(2). The signed copy need not be obtained from overseas and indirect customers in certain cases: r 5-30(3). The Warrants and Derivatives Risk Warning Notices are prescribed forms in appendices to the rules. The Generic Risk Disclosure Statement for Futures and Options agreed between the US Commodity Futures Trading Commission, the SFA and the Central Bank of Ireland may be used as an alternative to the Derivatives Risk Warning Notice in relation to futures, options on futures, options on commodities and options on equities: SFA Board Notice 197, 14 July 1994.

The Notice need only deal with the first four items if relevant. The remaining items are mandatory.²⁷⁸ A firm may include descriptions of the types of investment covered by the Notice, provided this does not lessen the effect of the risk warnings.²⁷⁹ The warning notice may also be included in a two-way customer agreement,²⁸⁰ though the customer must sign the warning notice separately to indicate that the customer has read and understood the warnings.

Non-readily realisable investments. Before recommending a transaction in these investments²⁸¹ to a private customer, a firm must:

- warn the customer about the difficulties in establishing a proper market price
- if the recommendation involves a purchase, warn about the difficulty of making a subsequent sale
- disclose any position knowingly held by the firm or an associate in the investment or a related investment.²⁸²

The warning may be oral or it may be included in a written customer agreement.²⁸³

Margin calls

A firm effecting a contingent liability transaction for a private or non-private customer must take reasonable care to satisfy itself that the customer is aware

²⁷⁸ Cf the Warrants Notice, which may not be amended.

²⁷⁹ SFA Rules, Appendix 15, Note to firms.

²⁸⁰ See infra at 75-76.

²⁸¹ A non-readily realisable investment is an investment (including a warrant or derivative) which is not traded frequently on or under the rules of a recognised or designated investment exchange and which is not a life policy, a unit in a regulated collective investment scheme or a foreign exchange transaction.

²⁸² r 5-30(5). An "associate" includes other undertakings in the same group as the firm, appointed representatives of such an undertaking or the firm and any person whose business or personal relationship with any of these could reasonably be expected to give rise to a community of interest between them which may involve a conflict of interest in dealings with third parties: r 9-1 definition of "associate". A related investment would include warrants, options or futures based on the first investment, or debt investments in the same company where the first investment was an equity (White, supra note 233 at 154).

²⁸³ There is a model clause which deals with non-readily realisable investments. However, this does not cover the disclosure of any position held by the firm or an associate.

of the consequences of not paying margin calls. Furthermore, it must not

effect the transaction unless it can show that it reasonably believes that the customer understands:

- the circumstances and form in which margins may be required
- the consequences of failing to honour margin calls, including possible close out of the customer's position
- circumstances, other than failure to satisfy a margin call, which may lead to close out without prior reference to the customer.²⁸⁴

Customer agreements

Customer agreements explain the basis on which the firm provides investment services.

Two-way customer agreements

The SFA rules have detailed requirements for "two-way customer agreements". A two-way customer is "an agreement in written form to which the customer has signified his assent in writing in circumstances where the firm is satisfied that the customer has had a proper opportunity to consider its terms".²⁸⁵

A two-way customer agreement is required for:

- private customers where the investment services involve contingent liability transactions and
- all private and non-private customers where the investment services involve discretionary management of the customer's assets.²⁸⁶

The two-way customer agreement requirement does not apply to indirect customers²⁸⁷ or to overseas customers whom the firm reasonably believes do not want such an agreement.²⁸⁸

²⁸⁴ r 5-28(2). The margin explanations must be in the mandatory two-way customer agreement in the case of private customers.

²⁸⁵ r 9-1, definition of "two-way customer agreement". Cf a one-way customer agreement which is simply sent to the customer.

²⁸⁶ r 5-23(2). The SFA has extended the requirements of the SIB Core Conduct of Business Rule regarding discretionary management which relates to private customers only. Discretionary management is not defined. However, it appears not to include a contingent order placed by the customer: White, *supra* note 233 at 136-137. Contingent liability transactions are defined in r 9-1: see *supra* note 262.

All two-way customer agreements must include:²⁸⁹

- a statement of the services to be provided
- the basis upon which the firm will charge for its services
- any restrictions on the investments which may be acquired or a statement that there are no such restrictions
- a statement of the customer's investment objectives (except in the case of execution-only services).²⁹⁰

Two-way customer agreements must also include the following information if applicable:²⁹¹

- the extent of the discretion to be exercised by the firm
- whether off-exchange transactions or transactions in non-readily realisable investments may be undertaken
- the basis on which the customer will incur any contingent liability, including margining requirements
- a statement of the basis on which the firm may receive remuneration from another person in connection with transactions entered into for the customer
- the maximum amount or percentage of a portfolio or account available for investment in contingent liability transactions
- any client money protections applicable to the customer
- any rights of the firm to realise assets or to close out positions.

²⁸⁷ r 5-23(2)(b). The firm must still have a two-way agreement with the agent to cover the agent's principal (White, supra note 233 at 138).

²⁸⁸ r 5-23(2). The onus is on the firm to show that it has such a reasonable belief. The firm must keep evidence to support its belief that the customer does not require or will not sign any written communication required to be sent or signed under the Conduct of Business Rules (White, supra note 233 at 138).

²⁸⁹ Table 5-23(4)(a).

²⁹⁰ The statement of investment objectives may be included in a separate document attached to the customer agreement to which the customer's attention is drawn. White suggests that this could be complied with by reference to a questionnaire completed by the customer: supra note 233 at 147.

²⁹¹ Table 5-23(4)(b).

Other written agreements

Even where a two-way agreement is not required, a firm providing investment services to a private customer on written contractual terms must set out in sufficient detail the basis on which those services are provided.²⁹²

SFA Fair and clear communications

A firm may only make an oral or written communication with another person to promote the provision of investment services if it can show that it reasonably believes that the communication is fair and not misleading.²⁹³ This requirement applies to all customers and non-customers. A firm must also take reasonable steps to ensure that any agreement, communication, notification or information provided to a private customer to whom it provides investment services is presented fairly and clearly.²⁹⁴

Exclusion clauses

In general, a firm cannot exclude liability under the Financial Services Act, the relevant SRO rules, contract or the law of negligence in agreements with private customers and sometimes other customers.²⁹⁵

Information about a firm

A firm must take reasonable steps to ensure that private customers are given adequate information about the firm's identity, business address and regulation by the SFA, and the identity, and status within the firm, of its employees and other agents who have contact with the customer.²⁹⁶

²⁹² r 5-23(1), discussed in White, supra note 233 at 138-139.

²⁹³ r 5-15(1).

²⁹⁴ r 5-15(2). White suggests (supra note 233 at 140) that the r 5-15(2) requirement that the presentation be made "clearly" perhaps indicates that the communication must be presented in a readily understandable way, whereas the r 5-15(1) requirement that the communication be "not misleading" means that it must not contain anything that is false or gives an incorrect impression.

²⁹⁵ r 5-24, discussed in White, supra note 233 at 141-145.

²⁹⁶ r 5-16, discussed in White, supra note 233 at 145-146.

SFA Approach

The SFA considers that while customer agreement obligations should remain, "the customer agreement is not necessarily the best medium to give risk warnings and explain all of the potential future liabilities of a customer".²⁹⁷ It has expressed concern about the length and detail in many customer agreements and whether the agreements adequately deal with the continuing relationship between the parties.²⁹⁸ It therefore emphasises specific disclosures outside the customer agreement and at relevant times.²⁹⁹

Prospectus disclosure

Prospectus disclosure obligations under Part IV of the Financial Services Act apply to the offer of securities to be quoted on the London Stock Exchange. "Securities" includes, broadly speaking, shares, debentures, certificates representing shares and warrants³⁰⁰ or other instruments entitling the holder to

²⁹⁷ Id at 134.

²⁹⁸ White (supra note 233 at 133-135) identifies problems with customer agreements in practice:

- they may be long, detailed and difficult for customers to understand due to the tendency of firms to include matters not strictly required, but which the firms wish to include to protect themselves
- private customers may in practice be unable to negotiate variations from a firm's standard terms
- agreements may not be signed before dealing, as the customer and firm are continuing to negotiate the terms of the agreement
- customers may not read and assimilate the information in the agreement before signing it because they are keen to do some form of investment business as soon as possible
- the relationship between the customer and investment firm may continue over a long period and the customer may forget the detail of the agreement.

²⁹⁹ "SFA saw value in not requiring formal customer agreements in too many cases, but, instead, requiring specific disclosures to be made to, or consents obtained from, customers before certain types of business could be done with them. The advantage of this approach is that the customer is put on notice about the important factors relating to a new type of business at the point at which it specifically affects him, rather than reading the details months or years before in a standard document when the warnings or disclosures are not relevant to the type of business which he is then involved in with the firm": White, supra note 233 at 134-135.

³⁰⁰ "Warrants" refers in this context to options to subscribe for shares, not the type of warrants traded on the ASX warrants market.

subscribe for shares. Part IV applies to capital raising issues of new securities and the quotation of existing securities on the Exchange.³⁰¹

Part III of the Companies Act 1985³⁰² applies to an offer to the public for subscription or purchase of shares or debentures. Part III does not apply to London Stock Exchange quotations,³⁰³ or to offers that are not public offers under the Companies Act.

Fees and benefits

A firm must disclose to a private customer the basis or amount of its charges for its investment services and the nature or amount of any other remuneration receivable by it (or to its knowledge, by its associate) and attributable to the investment services.³⁰⁴ The amount must not be unreasonable in the circumstances.³⁰⁵ This disclosure need not be written but must be made before providing the services.

Suitability

The SIB and SFA suitability obligations have two elements:

- a firm must seek information about its customers' circumstances and investment objectives in fulfilling its responsibilities to them³⁰⁶
- any recommendation or transaction must be suitable for the customer.³⁰⁷

³⁰¹ CCH Financial Services Reporter, para 10-950.

³⁰² Pt III is expected to be repealed as a result of the EC Public Offers Directive. Pt III's intended replacement, Pt V of the Financial Services Act, is apparently unlikely to be brought into force due to the difficulty of adapting Pt V to meet the Directive's requirements: CCH Financial Services Reporter, paras 10-500, 11-680.

³⁰³ Companies Act 1985 s 60(8).

³⁰⁴ r 5-33(2). There is an exemption for charges or remuneration in the form of commission received from another customer as a result of a simultaneous matching transaction: r 5-33(3).

³⁰⁵ r 5-33(1).

³⁰⁶ SIB Statements of Principle, Principle 4.

³⁰⁷ r 5-31.

Information about customers

A firm is required to "seek from customers it advises or for whom it exercises discretion any information about their circumstances and investment objectives which might reasonably be expected to be relevant in enabling it to fulfil its responsibilities to them".³⁰⁸

This obligation applies to all private and non-private customers but not non-customers. If a customer withholds information, the firm may rely on whatever information the customer has disclosed and any other information of which the firm should reasonably be aware.³⁰⁹

Suitable recommendations or transactions

Where a firm:

- makes a personal recommendation³¹⁰ to a private customer of any specific investment³¹¹ or to enter into a discretionary management agreement or
- effects or arranges a discretionary transaction with or for any private or non-private customer³¹²

the recommendation or discretionary transaction must be suitable for the customer "having regard to the facts disclosed by that customer and other relevant facts about the customer of which the firm is, or reasonably should be, aware".³¹³ This appears to impose an obligation on a firm to maintain

³⁰⁸ SIB Statements of Principle, Principle 4. This applies to all authorised persons.

³⁰⁹ White, supra note 233 at 165.

³¹⁰ White suggests (supra note 233 at 166) that it must be a personal recommendation and that therefore it would not apply to recommendations given in brokers' newsletters and other research material, unless these were personally styled so as to be perceived by the customer to be a personal recommendation.

³¹¹ According to White (supra note 233 at 166-167), a recommendation about the market generally would not be caught.

³¹² A discretionary transaction is not defined, but appears to include any transaction which the firm enters into without prior reference to or specific instructions from the customer: White, supra note 233 at 167.

³¹³ r 5-31(1). Where the firm has pooled a customer's funds with those of others, with the customer's agreement, the suitability requirement is to take reasonable steps to ensure that transactions are suitable for the fund, having regard to the fund's stated investment objectives: r 5-31(2).

current information on the customer's circumstances and investment objectives.³¹⁴

There may also be a duty to warn the customer if an execution-only dealing is obviously unsuitable.³¹⁵

Investment managers³¹⁶ have an ongoing obligation to ensure that discretionary portfolios for any private or non-private customer and advisory portfolios for private customers remain suitable, having regard to the facts disclosed by the customer or facts of which the firm is, or reasonably should be, aware. This requires a firm to keep the customer's account or portfolio under continuous review.

Problems and issues

One commentator has identified the following issues:

- does the transaction have to be the most suitable for the customer in the circumstances or is the requirement only that it must not be unsuitable?
- what is the position where there are several possible suitable transactions?
- to what extent does suitability require a survey of the whole market to determine what type of investment is suitable and, within that type, the particular investment which the customer should hold?
- to what extent is suitability a subjective test?³¹⁷

³¹⁴ This is supported by the SFA requirement to keep records of the "main details obtained by the firm about the customer's circumstances and investment objectives, including the date on which the information was last updated or checked": SFA Rules, Appendix 18 - Record Keeping Schedule Pt II.

³¹⁵ SIB Statements of Principle, Principle 1 (requiring a firm to observe high standards of integrity and fair dealing) or Principle 2 (obliging a firm to act with due skill, care and diligence): White, *supra* note 233 at 168-169.

³¹⁶ An investment manager is "a person who, acting only on behalf of a customer, either:

- manages an account or portfolio in the exercise of discretion or
- has accepted responsibility on a continuing basis for advising on the composition of the account or portfolio": r 9-1, definition of "investment manager".

White deals (*supra* note 233 at 170-171) with some of the difficulties in interpreting the definition of investment manager.

³¹⁷ White, *supra* note 233 at 167-168.

Financial supervision

A firm must maintain in cash, or assets easily convertible into cash, financial resources in excess of its "financial resources requirement" determined according to:

- the nature of the firm's operations
- its past expenditure
- its current investments and
- the amount owed by its customers.³¹⁸

There are detailed record keeping requirements. The records must be kept current³¹⁹ and must show and explain the firm's transactions and financial commitments. In particular, they must:

- disclose with reasonable accuracy the firm's financial position at any time over the preceding six years when the firm was an SFA member
- demonstrate whether the firm is complying with the financial resources requirement
- enable the firm to prepare within a reasonable time any financial reporting statements required by the SFA.³²⁰

Internal controls

A firm must ensure that its internal financial control systems are effective, taking into account:

- the size of its business
- the diversity of its operations
- the volume, size and frequency of transactions
- the risk associated with each area of its operations

³¹⁸ The "financial resources requirement" is made up of a primary requirement, a position risk requirement and a counterparty risk requirement: SFA Rules Table 3-61. The SFA attempts to ensure flexibility in the application of the financial resources requirement based on a periodic assessment of the quality of a firm's proprietary systems, valuation models, internal controls and personnel.

³¹⁹ r 3-10(1).

³²⁰ r 3-10(2).

- senior management's control of day-to-day operations

- the degree of centralisation
- its data processing methods.³²¹

The controls must be designed to ensure that:

- all transactions and commitments are recorded and are within the firm's authority
- there are procedures to safeguard assets and control liabilities
- there are measures to minimise the risk of losses to the business from fraud or error and to identify such matters to enable prompt management action.³²²

Risk Management

A firm must maintain records disclosing financial and business information enabling the firm's management to:

- identify, quantify, control and manage the firm's risk exposures
- make timely and informed decisions
- monitor the performance of all aspects of the firm's business on an up-to-date basis
- monitor the quality of the firm's assets
- safeguard the firm's assets, including those belonging to others for which the firm is responsible.³²³

A firm must also ensure that its accounting and other records detail exposure limits for trading positions.³²⁴ The information must be capable of being summarised so that actual exposures can be measured readily and regularly against the limits.

³²¹ r 3-12(3)(a), (b).

³²² r 3-12(3)(c).

³²³ r 3-12(2).

³²⁴ r 3-12(1).

Advertising

General requirements

An investment advertisement can only be issued by or with the approval of an authorised person.³²⁵ The definition of investment advertisement is extremely broad.³²⁶ Advertisements which are:

- incidentally investment advertisements
- issued to persons appearing sufficiently expert to understand any risks involved

are exempted.³²⁷

A firm in issuing or approving an investment advertisement must:

- apply appropriate expertise
- be able to show that it believes on reasonable grounds that the advertisement is fair and not misleading.³²⁸

There are very detailed requirements for the contents of advertisements. They include risk warnings for certain types of investments.³²⁹

A firm may only make an oral or written communication with another person which is designed to promote the provision of investment services if it reasonably believes that it is fair and not misleading.³³⁰ Similarly, a firm must take reasonable steps to ensure that any written agreement, communication, notification or information which it gives or sends to a private customer to whom it provides investment services is presented fairly and clearly.³³¹

³²⁵ Financial Services Act s 57(1). For "authorised person", see supra note 209.

³²⁶ Financial Services Act s 57(2).

³²⁷ Financial Services Act s 58(3)(b), (c). The Minister must specify these and other exemptions: s 58(3). White, supra note 233 at 207-210, lists the relevant exempting orders.

³²⁸ r 5-9(1).

³²⁹ r 5-9(7)-(9).

³³⁰ r 5-15(1).

³³¹ r 5-15(2).

Unsolicited calls

A firm may not enter into an investment agreement through unsolicited business calls unless permitted by regulation.³³² An unsolicited call is a personal visit or oral communication made without express invitation.³³³ Any investment agreement entered into in breach of the provision is generally unenforceable against the person called who may recover any money or property paid under the agreement, together with compensation for any loss suffered.³³⁴

Calls to:

- recognised professional body members³³⁵
- "non-private investors"³³⁶ and
- private investors who are existing customers, where the customer relationship is such that the investor envisages unsolicited calls of the kind concerned³³⁷

are exempt from the prohibition.

A firm which intends to begin making permitted unsolicited calls (including futures and options funds and geared futures and options funds) must give prior notification to the SFA.³³⁸ There are standards of conduct for permitted unsolicited calls, aimed at ensuring that the investor understands the purpose of the call and the kind of investment and investment services to be discussed.³³⁹ A firm must have procedures to ensure that its employees comply with the rules on unsolicited calls to private investors.³⁴⁰

³³² Financial Services Act s 56(1), SIB Rules Ch IV Common Unsolicited Calls Regulations.

³³³ Financial Services Act s 56(8).

³³⁴ Financial Services Act s 56(2).

³³⁵ SIB Common Unsolicited Calls Regulations, Introduction cl 3.

³³⁶ Id, r 1. A non-private investor is a person who is not a private investor: definition in SIB Rules Ch III Financial Services Core Glossary. The definitions of private and non-private investor differ from those of private and non-private customer. "Non-private investors" includes all non-individuals and individuals acting in the course of carrying on an investment business.

³³⁷ SIB Common Unsolicited Calls Regulations r 4.

³³⁸ r 5-17(2).

³³⁹ r 5-18.

³⁴⁰ r 5-17(1).

Transaction reporting

Report to SFA

A firm must notify the SFA of on and off-exchange transactions in any investments.³⁴¹ Exceptions include:

- contracts for differences other than equity index options futures and
- futures or options on commodities and currencies.³⁴²

Generally, a firm need not report a transaction which has already been reported to a qualifying exchange.³⁴³

Confirmation notes

A firm which effects a sale or purchase of an investment which is a derivative (option, future or contract for differences) with or for a customer must send the customer a confirmation note containing the essential details of the transaction.³⁴⁴ Non-private customers may decline a confirmation note for certain types of transactions.³⁴⁵

Valuations

A firm acting as the customer's investment manager must provide a valuation in respect of any derivatives or derivatives-related cash balances in the customer's account at least monthly.³⁴⁶ Where the firm is not acting as investment manager, it need only provide the valuation for certain derivatives which are contingent liability investments.³⁴⁷ The valuation reports must show

³⁴¹ r 5-49.

³⁴² r 5-49(2)(d), (e), (f), (h).

³⁴³ r 5-49(4).

³⁴⁴ r 5-34(1). This requirement does not apply to market counterparties, as they are non-customers. Where a firm enters into a futures transaction which closes out a position, the confirmation note must also show the customer's profit or loss arising out of the closing out.

³⁴⁵ r 5-34(11).

³⁴⁶ r 5-35(5).

³⁴⁷ r 5-35(5A). Valuation is not required of:

- off-exchange transactions entered into with or for a non-private customer
- written call options which are covered by the customer having the underlying instruments

changes in value and the aggregate of each of cash, collateral value, management fees and commissions attributable to transactions in relation to futures, options and related cash balances. In addition, the valuation reports for futures must show profit or loss on closed positions and unrealised profit or loss on open positions, while valuation reports for options must give information about trade, market and exercise prices for open options.³⁴⁸

Protection of client money

A firm must segregate client money³⁴⁹ by depositing it in a client bank account with an "approved bank".³⁵⁰ The firm must obtain the bank's acknowledgment that:

- funds held in the account are held by the firm as trustee
- the bank cannot exercise any right of set-off against the money and
- any interest payable will be credited to that or a similar account.³⁵¹

Client funds may be pooled in the one account. The segregation requirements apply to all on and off-exchange transactions for private customers, experts, ordinary business investors and authorised persons.³⁵² Certain types of clients may waive this segregation requirement.³⁵³

Compensation funds

-
- written put options covered by the customer having the cash available to meet the obligations (by deposit of the cash or of collateral).

³⁴⁸ r 5-35.

³⁴⁹ Client money is any money which a firm holds in respect of an investment agreement with or for a client (SIB Rules Ch VI Financial Services (Client Money) Regulations reg 2.01(1)) and which is not immediately due and payable to the firm for its own account: reg 2.04(1). For other circumstances in which money is not client money, see regs 2.02 and 2.04.

³⁵⁰ Id, reg 2.05.

³⁵¹ Id, reg 2.06. There are special rules relating to client money held on behalf of private customers in a client account outside the United Kingdom (reg 2.14) and proposed new rules relating to funds transferred to overseas brokers and settlement agents.

³⁵² For "authorised person", see supra note 209.

³⁵³ Id, reg 2.02. For further discussion of the treatment of client money in the UK, see Little, supra note 222 at 35-36.

The Investors Compensation Scheme under the SIB Rules³⁵⁴ applies where authorised persons³⁵⁵ are unable or are likely to be unable to satisfy civil

³⁵⁴ SIB Rules Ch IX Financial Services (Compensation of Investors) Rules 1990.

³⁵⁵ For "authorised person", see supra note 209.

liability claims against them in respect of their investment business. SFA members are covered by the scheme. Claims may only be made by eligible investors.³⁵⁶ There is currently a cap of £48,000 on the amount of compensation payable.³⁵⁷

Summary: protections by category of customer

Private customers have the following protections:

- exchange-trading requirement (no contingent liability transactions except currency risk hedges to be off-exchange)
- suitability requirements
- risk disclosure
- charges disclosure
- advertising controls
- transaction reporting obligations
- confirmation notes, difference accounts and valuations requirements
- communications controls (not misleading and presented fairly)
- client funds segregation requirements.

Non-private customers have the following protections:

- suitability requirements (discretionary transactions)
- advertising controls
- transaction reporting obligations
- confirmation notes and difference accounts (unless opted out of) and valuations (some transactions)
- communications controls (not misleading)
- client funds segregation requirements (some non-private customers).

Non-customers (market counterparties) have more limited protections, namely:

³⁵⁶ Financial Services (Compensation of Investors) Rules 1990, reg 2.02(2). "Eligible investor", defined in the Glossary to the Rules, is confined primarily to private customers, thereby excluding professional investors and business investors.

³⁵⁷ *Id.*, reg 2.07(1).

- advertising controls
- transaction reporting obligations
- communications controls (not misleading)
- client funds segregation requirements (only authorised persons³⁵⁸ and unless consent not to segregate).

The protection against unsolicited calls applies to various "private investors". Compensation fund claims are limited to eligible investors (excluding professional investors and business investors). All firms must comply with the financial supervision requirements.

Gaming and wagering legislation

Gaming and wagering legislation does not apply to transactions regulated by the Financial Services Act.³⁵⁹

Netting

Introduction

A special insolvency netting regime for "market contracts" (broadly, contracts entered into on an exchange or under the rules of an exchange) came into force in 1991 under Part VII of the Companies Act 1989. No legislative provisions deal directly with the enforceability of netting in OTC financial markets.³⁶⁰ Instead, general insolvency law principles apply.

³⁵⁸ For "authorised person", see supra note 209.

³⁵⁹ Financial Services Act s 63.

³⁶⁰ Group of Thirty Report, Appendix II, Opinion of Linklaters & Paines at 167; EJ Nalbantian, PS Smedresman and T Hoser, "Netting and derivatives - a practical guide", (1993) 12 (9) IFLR 38 at 40. This is perhaps subject to the qualification that off-exchange contracts which are entered into between a futures or options exchange member and the member's client and which are matched by equal and opposite on-exchange contracts are intended to be "market contracts" within Pt VII: see Department of Trade and Industry, *Consultative Paper on Implementation of Part VII of the Companies Act 1989*, August 1990, (DTI Consultative Paper) Annex 1 and DTI, Draft Regulations Paper, February 1991, para 11. The Guidance Note of the Financial Law Panel on Netting of Counterparty Exposure deals with the impact of these insolvency law principles on OTC transactions.

Exchange-related financial markets

The stated purpose of Part VII is "safeguarding the operation of certain financial markets by provisions with respect to -

- (a) the insolvency, winding up or default of a person party to transactions in the market...,
- (b) the effectiveness or enforcement of certain charges given to secure obligations in connection with such transactions,...and
- (c) rights and remedies in relation to certain property provided as cover for margin in relation to such transactions or subject to such a charge....³⁶¹

Part VII was intended to remove legal uncertainties about netting for on-market and other "market contracts".³⁶² The provisions "are principally intended to protect the integrity of the market place; the legislation does not seek to protect individual brokers from the consequences of insolvent default of customers nor does it seek to protect customers in the event of insolvent default by their broker".³⁶³

Market contracts

Definition

Part VII applies to contracts "connected with a recognised investment exchange or recognised clearing house".³⁶⁴ These "market contracts" are, in the case of a recognised investment exchange:

- (a) contracts entered into by a member or designated non-member of the exchange which are either
 - (i) contracts made on the exchange...; or

³⁶¹ s 154.

³⁶² DTI Consultative Paper, supra note 360 paras 7-8.

³⁶³ CFTC, International Regulation 1994 at 173.

³⁶⁴ s 155(1). A recognised investment exchange must satisfy certain Financial Services Act requirements. Although some overseas investment exchanges are recognised (including the Sydney Futures Exchange), Pt VII only applies to contracts entered into by the recognised overseas investment exchange itself in connection with the provision of clearing services: s155(2A). See DTI Draft Regulations Paper, supra note 360 paras 12, 47-51.

- (ii) contracts in the making of which the member or designated non-member was subject to the rules of the exchange...and
- (b) contracts subject to the rules of the exchange entered into by the exchange for the purposes of or in connection with the provision of clearing services.³⁶⁵

Only one of the parties to the contract need be a member or designated non-member of the exchange.³⁶⁶ A designated non-member is "a person in respect of whom action may be taken under the default rules of the exchange but who is not a member of the exchange".³⁶⁷ The default rules must have adequate procedures to ensure that persons are only designated if their failure to meet market contract obligations would be likely adversely to affect the operation of the market.³⁶⁸ This requirement reflects the underlying purpose of the legislation in protecting the integrity of the market.³⁶⁹

For recognised clearing houses, market contracts are those which are subject to the rules of the clearing house and entered into by the clearing house to provide clearing services for a recognised investment exchange.

Under ss 170-172, not yet in force, Part VII may be extended to contracts on overseas investment exchanges and clearing houses and certain money market institutions.

Default rules

Recognised investment exchanges must have default rules enabling action to be taken over unsettled market contracts where an exchange member or a designated non-member appears unable (or likely to become unable) to meet

³⁶⁵ s 155(2).

³⁶⁶ DTI Consultative Paper, supra note 360 para 11.

³⁶⁷ s 155(2).

³⁶⁸ Sch 21, para 4. The unusual nature of this enlarged "jurisdiction" has been noted (CCH Financial Services Reporter para 94-900):

"It is a radical step for the law to sanction the exercise of control by a voluntary body over non-members and the rules are strict and precise for designating such non-members who may be subject to this control."

³⁶⁹ The DTI comments (Consultative Paper, supra note 360, para 21; see also para 11):

"It is recognised that there may be some users of some exchanges who, while not being members, contract with such frequency and in such volume that were they to default, the direct effect on the market might be as great, if not greater, than in the case of a member's default."

market contract obligations.³⁷⁰ Similarly, a recognised clearing house must have rules for closing out a member's or designated non-member's position where necessary.³⁷¹

Recognised investment exchange and clearing house rules must provide for the discharge of all rights and liabilities under unsettled market contracts and require a set-off of amounts payable between the same parties to produce a net sum which the exchange certifies as payable (the certified net sum).³⁷²

A person entering into market contracts which are margined transactions is regarded as acting in different capacities, according to whether or not money held or received in respect of the transactions is "client money".³⁷³ In the event of default, the exchange or clearing house will net off the segregated positions separately and report separate net sums in respect of client and other accounts.³⁷⁴

Modification of general insolvency law

General insolvency law is subject to the rules of recognised investment exchanges and clearing houses governing market contracts and default procedures.³⁷⁵ In particular, the powers of any insolvency office holder (for instance a liquidator or trustee in bankruptcy) are subject to the default rules of these investment exchanges and clearing houses.³⁷⁶

³⁷⁰ Sch 21, para 1.

³⁷¹ Sch 21, para 8.

³⁷² Under exchange rules, a certified net sum will be owed to or by a defaulting member or designated non-member in the case of each client: Sch 21, para 2. The certified net sum under recognised clearing house rules will be payable either to or by the clearing house. The clearing house rules must also provide that any certified sum owed to the clearing house is set off against margin deposited by the defaulting member with the clearing house and that any certified sum owed by the clearing house must be aggregated with the client's margin: Sch 21, para 9 (see also paras 1(4), 7 and 9 for exchanges which provide their own clearing services).

³⁷³ s 187, Financial Markets and Insolvency Regulations 1991 reg 16. The client money protection applies to several categories of clients, although most (other than private customers) may waive it.

³⁷⁴ DTI Consultative Paper, supra note 360 Annex 2. See also Derivatives Guide (United Kingdom) *International Financial Law Review Special Supplement* January 1992 at 35.

³⁷⁵ ss 158, 159.

³⁷⁶ s 159(2).

The certified net sum³⁷⁷ must be accepted for proof by the insolvency office holder and taken into account in applying the set-off provisions of the Insolvency Act 1986 as if it had been a net debt (or credit) before the commencement of the bankruptcy or liquidation.³⁷⁸ However, this is subject to the insolvency office holder recovering any profit arising from any contract entered into with notice of a pending insolvency.³⁷⁹

A number of the Insolvency Act provisions are expressly excluded, for instance, the power of the insolvency office holder to disclaim onerous contracts³⁸⁰ or to have pre-insolvency transactions set aside as preferences.³⁸¹

Part VII default proceedings³⁸² also override general insolvency law in that:

- relevant debts or other liabilities arising from market contracts may not be proved in any liquidation or bankruptcy or taken into account for set-off until completion of the default proceedings³⁸³

³⁷⁷ See supra note 372.

³⁷⁸ s 163.

³⁷⁹ s 163(4).

³⁸⁰ Sections 178, 186, 315 and 345 of the Insolvency Act do not apply in relation to a market contract or a contract effected by the exchange or clearing house for the purpose of realising property provided as margin in relation to market contracts: s 164(1). However, the value of any profit from a market contract entered into or margin accepted by a person with knowledge of the presentation of a bankruptcy or winding up petition or meeting of creditors in respect of the other party is recoverable from the person by the insolvency office holder: s 164(4).

³⁸¹ Sections 239 and 340 of the Insolvency Act do not apply in relation to a market contract to which a recognised investment exchange or clearing house is a party or which is entered into under its default rules and a disposition of property in pursuance of such a market contract: s 165. For other examples, see s 161(4) (restrictions on taking legal proceedings which might affect the default proceedings of an exchange or clearing house), s 164(3) (avoidance of property dispositions effected after commencement of winding up or presentation of a bankruptcy petition) and s 165 (setting aside transactions at an undervalue and transactions defrauding creditors).

³⁸² Insolvency office holders may apply to the Secretary of State to clarify whether a recognised investment exchange or clearing house intends to initiate default proceedings: s 167. Office holders are not liable for actions taken over a defaulter's property if they reasonably believe that they are entitled to so act, except for any loss caused by their negligence: s 184(1). These office holders may also seek court orders to prevent improper dissipation of assets: s 161(1).

³⁸³ s 159(4). However, the chairman of the creditors' meeting may accept an estimate of a debt likely to be certified as payable for the purpose only of determining the creditor's entitlement to vote and be a member of a creditors' committee: s 159(5).

- a defaulter's liquidator or trustee may not declare or pay a dividend or return any capital unless an adequate reserve for claims arising from the default proceedings is retained.³⁸⁴

SIB powers of direction

The SIB may direct a UK recognised investment exchange or clearing house to take (or not to take) action under its default rules.³⁸⁵ The SIB may not give a direction without first consulting the exchange or clearing house to ensure that its direction would not involve undue risk to investors or other market participants or would not otherwise be undesirable.³⁸⁶ A direction not to take default proceedings cannot be given, or ceases to have effect, if the defaulter is, or becomes, insolvent.³⁸⁷

Market charges

Part VII modifies the application of the Insolvency Act to "market charges".³⁸⁸

The general insolvency law moratorium on enforcement of charges while a petition for an administration order is pending or in force does not apply to

³⁸⁴ s 161(2).

³⁸⁵ s 166(2).

³⁸⁶ s 166(3).

³⁸⁷ s 166(6). This section refers to the making of a bankruptcy, sequestration or winding up order and appointment of an interim receiver, administrative receiver or provisional liquidator.

³⁸⁸ Section 173 defines "market charge" as any fixed or floating charge granted:

- (a) in favour of a recognised investment exchange, for the purpose of securing debts or liabilities arising in connection with the settlement of market contracts,
- (aa) in favour of The Stock Exchange, for the purpose of securing debts or liabilities arising in connection with short term certificates;
- (b) in favour of a recognised clearing house, for the purpose of securing debts or liabilities arising in connection with their ensuring the performance of market contracts, or
- (c) in favour of a person who agrees to make payments as a result of the transfer or allotment of specified securities made through the medium of a computer-based system established by the Bank of England and The Stock Exchange, for the purpose of securing debts or liabilities of the transferee or allottee arising in connection therewith.

The Financial Markets and Insolvency Regulations 1991 regs 8, 10-13 further qualify this definition.

market charges.³⁸⁹ However, if the market charge ranks *pari passu* with or below a non-market charge over the same property, the court may direct that steps be taken after enforcement of the market charge to ensure that the other charge is not thereby prejudiced.³⁹⁰

The power of an administrator or administrative receiver to deal with property does not apply to property subject to a market charge, nor can a receiver appointed under a market charge be required to vacate office.³⁹¹

The statutory provisions which avoid dispositions of property after the commencement of winding up or presentation of a bankruptcy petition do not apply to the creation of a market charge.³⁹² However, any profit made by a party to the disposition (other than the chargee) may be recoverable by the insolvency office holder if the party was aware of the commencement of the winding up or presentation of the bankruptcy petition.³⁹³

Market property

Recognised investment exchanges or clearing houses may realise or dispose of property (other than land) held as margin in relation to a market contract. That property may be applied in accordance with the exchange or clearing house rules "notwithstanding any prior equitable interest or right, or any right or remedy arising from a breach of fiduciary duty, unless the exchange or clearing house had notice of the interest, right or breach of duty at the time the property was provided as margin".³⁹⁴ Also, a subsequent right or remedy may not be enforced if it interferes with the application of the property in accordance with the exchange or clearing house rules.³⁹⁵

In addition:

- a person to whom the exchange or clearing house disposes of the property takes free from any such interest, right or remedy³⁹⁶

³⁸⁹ s 175(1)(a).

³⁹⁰ s 175.

³⁹¹ s 175(1)(b), (3).

³⁹² s 175(4).

³⁹³ s 175(5).

³⁹⁴ s 177(2).

³⁹⁵ s 177(3).

³⁹⁶ s 177(4).

- a market charge has priority over an unpaid vendor's lien, unless the chargee had actual notice of it³⁹⁷
- no execution or distress may be levied by unsecured creditors against property held as margin in relation to market contracts or subject to a market charge, except with the consent of the exchange or clearing house (regarding margin) or the charge holder (regarding a market charge).³⁹⁸

OTC financial markets

The Financial Law Panel³⁹⁹ Guidance Note "Netting of counterparty exposure" (November 1993) contained a statement of law reflecting a consensus of insolvency and banking law practitioners.⁴⁰⁰

That statement, which applies to OTC transactions, restates Rule 4.90 of the Insolvency Rules 1986 which requires that mutual dealings be set off. It concludes:

"Where a bank and its corporate customer enter into various transactions with each other prior to the customer's insolvent liquidation and the customer goes into liquidation before the transactions are closed mandatory set off applies. The bank will have a claim (or obligation) on a net basis only to receive from (or pay to) the liquidator the net amount in respect of the transactions taken as a whole."⁴⁰¹

The guidance note indicates that the statement of law does not consider the position where:

³⁹⁷ s 179.

³⁹⁸ s 180.

³⁹⁹ The Financial Law Panel was set up in 1993 as a forum to consider and give practical solutions for legal uncertainties and anomalies affecting wholesale financial markets and services in the UK, to review and comment on UK and European Union legislative and regulatory proposals and to make law reform proposals. It comprises legal and accountancy practitioners and Treasury, commerce and industry representatives. In practice, the Panel will primarily provide a mechanism to establish custom and usage in the financial services industry. Its authority stems entirely from the standing of its members.

⁴⁰⁰ Financial Law Panel, Guidance Note, November 1993 at 2.

⁴⁰¹ Id, Sch 1.

- the counterparty's insolvency is governed by the law of another jurisdiction

- either party acts outside its legal powers in entering into the transaction or behaves unlawfully or improperly
- one or both parties is acting as agent for a third party
- the transactions are governed by the rules of an organised market or clearing system or other multilateral netting arrangement
- a party is aware of the counterparty's insolvency when the transactions are concluded
- the liquidation of a party has commenced before the transactions are concluded
- the transactions do not involve mutuality of dealing.⁴⁰²

The Department of Trade and Industry published a Consultative Paper (November 1993) on proposals to reform English insolvency law, including that companies using the proposed new insolvency procedure (similar to Part 5.3A of the Corporations Law) should be able to prevent termination of contracts in some or all circumstances. This may affect set-off rights and netting arrangements. The Financial Law Panel has since indicated to the Department of Trade and Industry in response to this consultation that no change should be made which would adversely affect the ability of the wholesale markets to use netting agreements.⁴⁰³

⁴⁰² Id at 3.

⁴⁰³ CCH Financial Services Reporter, para 96-384.

CHAPTER 4. CANADA

Scope of regulation

Regulatory overview

Canada does not have a single federal regime governing its capital markets. Derivatives are regulated by a network of federal and provincial statutes. OTCs make up the largest part of the derivatives markets. This is followed by exchange-traded derivative securities and exchange-traded commodity futures contracts.

The activities of chartered banks, the biggest dealers in OTC derivatives, are subject primarily to federal regulation. Other financial institutions which participate in the derivatives markets, such as trust and mortgage loan companies, insurance companies, credit union organisations and pension funds, can be regulated by either federal or provincial authorities.

Trading in securities and futures and the registration and capital requirements for conventional investment dealer intermediaries are governed by provincial securities and commodity futures legislation, administered by the provincial securities commissions. The majority of provinces have adopted substantially uniform legislation and the provincial commissions have formed a national organisation, the Canadian Securities Administrators which publishes national rules governing various aspects of securities regulation.

The Ontario Securities Commission (OSC) is the leading provincial securities commission and its rules, policies and governing statute, the Securities Act (Ontario) (Securities Act) are generally indicative of the Canadian position regarding derivatives regulation. This Chapter concentrates on Ontario and refers, where appropriate, to national developments.

"Derivative" is not a statutorily defined term. In practice, derivatives include products that fall within the definition of "securities", regulated under the Securities Act, and those that fall within the definition of "commodity futures contract" or "commodity futures option", regulated under the Commodity Futures Act (Ontario) (Commodity Futures Act). Products traded on the OTC markets have, in certain circumstances, been regarded as securities, though in practice they have been exempt from regulation by the OSC.

Role of SROs

The OSC has overall responsibility for administering both the Securities Act and the Commodity Futures Act. However, the supervision of derivatives trading is strongly focused on self regulation through The Toronto Stock Exchange, The Toronto Futures Exchange and the Investment Dealers Association of Canada. These organisations establish and enforce the registration and proficiency requirements and compliance rules for derivatives dealers, the rules for derivatives trading, and the minimum capital standards for registered dealers. The SROs are, in turn, regulated by the OSC.

Commodity Futures Act

Commodity futures contracts and commodity futures options that are traded on a commodity futures exchange are governed by the Commodity Futures Act. Any such contracts or options that are otherwise traded fall within the definition of "securities" regulated under the Securities Act. All other derivatives have also been treated as "securities" regulated by the Securities Act.

The term "commodity" is the cornerstone of Commodity Futures Act regulation. It means "whether in the original or a processed state, any agricultural product, forest product, product of the sea, mineral, metal, hydrocarbon fuel, currency or precious stone or other gem, and any goods, article, service, right or interest, or class thereof, designated as a commodity under the regulations".⁴⁰⁴

A "commodity futures contract" is "a contract to make or to take delivery of a specified quantity and quality, grade or size of a commodity during a designated future month at a price agreed upon when the contract is entered into on a commodity futures exchange, pursuant to standardised terms and conditions set forth in such exchange's by-laws, rules or regulations".⁴⁰⁵

A "commodity futures option" is "a right, acquired for consideration, to assume a long or short position in relation to a commodity futures contract at a specified price and within a specified period of time and any other option of which the subject is a commodity futures contract".⁴⁰⁶

⁴⁰⁴ Commodity Futures Act s 1.

⁴⁰⁵ Ibid.

⁴⁰⁶ Ibid.

While the Commodity Futures Act is the ultimate regulating statute, effective regulation of commodity futures is through The Toronto Futures Exchange which is a "registered commodity futures exchange" under the Commodity Futures Act. The OSC may disapprove any new or amended by-laws or rule of the exchange.⁴⁰⁷ In addition the OSC must approve the terms and conditions of exchange-traded contracts.⁴⁰⁸ All contracts are cleared through Trans Canada Options Inc.

Securities Act

The term "securities" is defined in the Securities Act by way of a broad inclusive list.⁴⁰⁹ The legislation regulates trades in securities through the registration and prospectus requirements.

Registration requirements

Persons who deal in or advise on securities must, unless exempt, be registered with the OSC. Generally speaking, registration exemptions under the Securities Act exist for:

- trades involving sophisticated parties and
- "blue chip" securities as set out in the Securities Act.⁴¹⁰

The philosophy which underpins these exemptions is that given the type of participant (an institution or otherwise sophisticated) or the nature of certain securities, the protection offered through registration is unnecessary. However, these exemptions have been largely made redundant by the introduction of a system of "universal registration" under the Securities Act regulations.⁴¹¹ This system requires registration by "market intermediaries" in respect of many trades that were formerly exempt. Market intermediary is broadly defined to include any persons or companies that engage in or hold themselves out as engaging in the business of trading in securities as principal or agent.⁴¹²

⁴⁰⁷ Commodity Futures Act s 20(2).

⁴⁰⁸ Commodity Futures Act ss 33-38.

⁴⁰⁹ Securities Act s 1.

⁴¹⁰ Securities Act ss 34, 35.

⁴¹¹ Securities Act Regulation Pt XI.

⁴¹² Id at s 204(1).

Prospectus requirements

A prospectus must be filed by any person whose trading in derivative securities amounts to a distribution.⁴¹³ A "distribution"⁴¹⁴ occurs where:

- an issuer issues previously unissued securities to investors
- any investor, while being a control person,⁴¹⁵ disposes of some or all of its securities
- investors who have acquired their securities in reliance on certain prospectus exemptions shortly thereafter⁴¹⁶ dispose of some or all of their shares.

Generally, the prospectus exemptions correspond to the registration exemptions.

The OSC may grant complete or conditional exemptions from the registration and prospectus requirements where it is satisfied that this would not prejudice the public interest.⁴¹⁷ These "Rulings" have often been applied to derivative securities, particularly to options. The OSC proposes to make a further ruling in relation to certain OTC derivatives.⁴¹⁸

Options

The OSC has ruled that trades in "recognized options", cleared through "recognized clearing organizations", are not subject to the Securities Act's registration and prospectus provisions, provided that before making such a trade the dealer has provided the investor with a standardised risk disclosure statement. This ruling is entitled the "Recognized Options Rationalization Order" (RORO).

⁴¹³ Securities Act s 53.

⁴¹⁴ Securities Act s 1.

⁴¹⁵ This is a person holding a sufficient number of shares of an issuer to affect materially the control of that issuer. Any holding of more than 20% of the outstanding voting shares is, in the absence of evidence to the contrary, deemed to affect materially the control of an issuer.

⁴¹⁶ s 72(4), (5), (6).

⁴¹⁷ Securities Act ss 74, 144.

⁴¹⁸ *Over-the-Counter Derivatives in Ontario - An OSC Staff Report and Draft Policy Statement* (1994).

"Recognized options" under RORO include equity options, debt options and index options traded on The Toronto Stock Exchange and debt options and precious metal options traded on The Toronto Futures Exchange. The list of "recognized options" is updated regularly.

The "recognized clearing organizations" are Trans Canada Options Inc for options on Canadian securities and Options Clearing Corporation for Canada-traded US options.

Options other than those recognised under RORO and commodity futures options under the Commodity Futures Act are treated as securities under the Securities Act.

OTC market in derivatives

In Ontario an OTC derivative is a derivative other than an exchange-traded option or futures contract. OTC derivatives transactions are customised contracts entered into without the interposition of clearing organisations. Until recently, the treatment of OTC transactions under the Securities Act was uncertain. However, in practice, the OSC, along with other provincial securities authorities, avoided directly regulating these activities, given the sophistication of the participants. The primary suppliers of the OTC products were federally chartered banks while the primary users were sophisticated managers of large portfolios. However, indirect regulation applied through the SROs imposing minimum capital requirements and trading rules on their members, which covered some of their activities involving OTC derivatives. Further, most of the financial institutions involved in these activities were subject to other regulatory supervision by federal⁴¹⁹ or provincial authorities.⁴²⁰

In January 1994 the OSC released for comment a staff report on OTC derivatives in Ontario and a draft policy statement.⁴²¹ The draft policy statement proposed a new regulatory framework for OTC derivatives. The report has not yet been adopted by the Commission.

⁴¹⁹ Office of the Superintendent of Financial Institutions.

⁴²⁰ In Ontario, the regulator of financial institutions is the Office of the Ministry of Finance.

⁴²¹ *Over-the-Counter Derivatives in Ontario - An OSC Staff Report and Draft Policy Statement* (1994).

1994 Report and draft Policy Statement

The OSC staff report recommended:

- clarification of the Securities Act's application to OTC derivatives trading
- wide exemptive relief from the registration and prospectus provisions of the Securities Act for certain OTC derivative transactions.

These recommendations formed the basis of a draft policy statement entitled "Interpretation of Transactions in OTC Derivatives" (the "Draft Interpretation") and a draft ruling ("the Draft Ruling").

OSC Report - A Regulatory Focus Only

As the OTC derivatives market is dominated by Canadian chartered banks, regulated by the federal Office of the Superintendent of Financial Institutions (OSFI), the Draft Interpretation and the Draft Ruling focused on registration and prospectus requirements rather than credit or systemic risk. The report did not deal with issues relating to netting, bankruptcy, accounting or taxation.

Products under consideration in the Report

The report focused on options and forwards together with products 'constructed' using these basic building blocks, such as swaps (a series of forwards), caps, floors and collars (which are really types of options strategies) and forward rate agreements.⁴²²

⁴²² In Canada, according to the Bank of Canada Report, the most important instruments in the OTC market are forward contracts on foreign exchange, which accounted for some 46% of the outstanding derivatives positions of the major six chartered banks in 1992, followed by domestic interest rate swaps at 24%. Forward rate agreements ranked next at 15%, followed by options at 10% (of these, interest rate options made up about 75% of the volume, with currency and equity options making up the remainder) and then interest rate futures contracts (including bond forward contracts) at 5%.

OTC Derivative - a defined term

The Draft Ruling defined an "OTC derivative" as an "option, forward or a contract for difference other than Excluded OTC derivatives"⁴²³ (all defined terms) which meet certain criteria. In summary, those criteria were that:

- the agreement is customised to the purposes of the user and is not part of a fungible [interchangeable] class of agreements which are standardised as to their material economic terms
- the creditworthiness of any party having an obligation is a material consideration in entering into the agreement
- the instrument is not exchange-traded or cleared through a clearing house
- the underlying interest is an interest rate or rates, Canadian or foreign currency, a forward exchange rate or rates, a security, a commodity, an index of market prices or levels of any or all of these, or some relationship between any or all of them, or some combination of them.

Regulation of Trades

The OSC staff's view was that transactions involving large institutions with sufficient expertise not to require Securities Act protection should be either totally exempt from the Act or at a minimum be exempt from the registration and prospectus requirements. It was also their view that the Commission's role in regulating OTC derivatives should be largely confined to trades involving securities offered to less-sophisticated participants.

The report proposed that regulatory relief also extend to parties using certain OTC derivatives for risk management, rather than speculation. The purpose for which a transaction was entered into would be determined from the surrounding circumstances.

⁴²³ An Excluded OTC derivative is one which is not a trade in a security according to the Draft Interpretation.

Summary

The Draft Interpretation

The OSC Draft Interpretation proposes to exclude from regulation under the Securities Act those OTC derivatives which are:

- transactions involving an interest rate/foreign exchange derivative where both parties to the transaction are either Qualified Parties⁴²⁴ or persons or companies who are exposed to interest rate or currency risk in their business and who enter into the transaction for risk management and hedging purposes
- transactions involving a Commodity Derivative (a defined term) where one of the parties is a Commercial User⁴²⁵ using the derivative for risk management, as opposed to speculation, and the other party is either a Commercial User or a Qualified Party.

All other transactions involving OTC derivatives (as defined above) would constitute trades in securities to be regulated under the Securities Act.

The Draft Ruling

The Draft Ruling deals with residual OTC derivatives, that is, those which are not excluded by the Draft Interpretation and thus are treated as trades in securities under the Securities Act. The Draft Ruling provides relief from the registration and prospectus requirements of the Securities Act for certain of these OTC derivatives being:

- all residual OTC derivatives transactions between Qualified Parties
- all residual OTC commodity derivative transactions where all parties are either Commercial Users or Qualified Parties
- all other residual OTC derivative transactions, where the transaction is effected through a broker/dealer and a risk disclosure statement is provided to the non-Qualified Party by the broker/dealer.

⁴²⁴ Qualified Parties are defined as certain banks, credit unions, brokers, individuals with a net worth of CN\$5 million (excluding their principal residence) and other specified bodies.

⁴²⁵ A Commercial User is defined as an entity which uses the commodity which underlies the derivative in its business.

Advisers and Dealers in the OTC Market

The OSC staff proposes that generally there be no requirement that persons trading in OTC derivatives as Qualified Parties and Commercial Users be registered with the OSC. However, persons advising on derivatives transactions which constitute trades in securities should be registered with the OSC.

Content of regulation

Exchange-trading requirement

Mandatory

Derivatives regulated under the Commodity Futures Act (commodity futures contracts and commodity futures options) and those options regulated under RORO must be exchange-traded.

Excluded

The definition of an OTC derivative in the OSC Draft Ruling provides that the instrument must "not be entered into and traded through an organised market or exchange or cleared by a clearing agency".

OTC wholesale activity

The OSC staff report on the OTC derivatives market notes that to date the end-users of derivatives products have mostly been large institutions or smaller organisations with a specialised interest in a certain type of derivative. The report identifies three reasons for this.

- Parties entering into transactions are required by their counterparties to have a sufficient credit rating.
- The transaction costs involved in derivative transactions have made it uneconomical to enter into many transactions under a CN\$10 million notional amount.
- There is a greater likelihood that the financial officers of large institutions will be familiar with the appropriate use of these products.

The Draft Ruling provides that an "OTC derivative" in which any party is not a Qualified Party or a Commercial User (a sophisticated party) is exempt from the registration and prospectus requirements of the Securities Act only where:

- . the transaction is customised
- . the transaction is effected through a registered broker/dealer and
- . the investor receives a risk disclosure statement.

Transactions that do not meet these criteria cannot be traded OTC and are subject to the registration and prospectus requirements.

Commodity Pool Programs

Generally, mutual funds in Ontario are regulated under the Securities Act and various National Policies.⁴²⁶ Mutual funds established solely for the purpose of investing in derivatives (commodity pool Programs⁴²⁷) are regulated by OSC Policy 11.4. The OSC sees Programs as highly speculative. Policy 11.4 does not control the type of derivatives in which the Program may invest, but seeks to protect investors through:

- . requirements for promoters, managers and advisers relating to experience, financial condition, investment obligations and reporting
- . suitability requirements for participants (the dealer must ensure the financial capacity of persons wanting to participate in the Program)
- . continuous disclosure obligations
- . rights of participants (the right to attend meetings, voting rights and rights of access to records)
- . disclosure and marketing requirements (a minimum capital requirement for the fund of CN\$500,000 and enhanced disclosure requirements for prospectuses).

⁴²⁶ National Policies are policy statements issued by the Canadian Securities Administrators. Mutual funds that include a power to invest in derivative products are regulated under National Policy 39.

⁴²⁷ These "Programs" deal with any "entity formed, whether a corporation or a limited partnership, and operated for the purposes of investing in commodity futures contracts and commodity futures and related products". Related products include stock index futures contracts or options and options on commodities whether or not exchange-traded.

OTC retail activity

The OSC staff foresees OTC derivative products being offered "down market" to retail investors and considers that the Commission should implement appropriate proficiency standards for organisations seeking to market such products to the public. Currently, the formal proficiency requirements of Securities Act registrants include very little on derivatives, and virtually nothing on OTC derivatives and the special risks and concerns that relate to these products.

The Canadian Securities Administrators are preparing a new National Policy on retail offerings of certain derivative securities (index and commodity warrants).

Licensing

A dealer or adviser must be registered under the Securities Act⁴²⁸ or Commodity Futures Act⁴²⁹ or operate under their exemptions.

Dealers and advisers in securities must, unless exempt, comply with the terms and conditions of registration in the Securities Act regulations.⁴³⁰ The OSC has the power to vary, suspend or cancel registration where, in its opinion, it is in the public interest to do so.⁴³¹ Persons exempt from registration may also have their exempt status removed on this basis.⁴³²

Similarly, dealers under the Commodity Futures Act (described as "futures commission merchants" and advisers must, unless exempt, be registered with the OSC.⁴³³ The Commodity Futures Act regulations set out the terms and conditions of registration.⁴³⁴ The OSC has the same powers of removal, suspension and variation as under the Securities Act.⁴³⁵ Only dealers who belong to The Toronto Futures Exchange may be registered under the Commodity Futures Act.

⁴²⁸ Securities Act Pts XI, XII; Securities Act Regulation Pt XI.

⁴²⁹ Commodity Futures Act Pts VIII, IX; Commodity Futures Act Regulation Pt III.

⁴³⁰ Supra note 428.

⁴³¹ Securities Act s 27.

⁴³² Securities Act s 128.

⁴³³ Supra note 429.

⁴³⁴ Ibid.

⁴³⁵ Commodity Futures Act s 24.

The conditions of registration in the Securities Act and the Commodity Futures Act regulations are similar and include obligations relating to:

- capital requirements (now superseded by the Joint Regulatory Financial Questionnaire and Report (see below at 116))
- record keeping
- creation of new accounts
- segregation of funds
- statements of account
- proficiency requirements.⁴³⁶

Once the OSC authorises derivatives dealers, the primary ongoing regulation of these registrants is by The Toronto Stock Exchange, The Toronto Futures Exchange and the Investment Dealers Association of Canada. Derivatives advisers are regulated directly by the OSC, not through any SRO.

The OSC's Draft Ruling on OTC derivatives proposes relief from the registration requirements of the Securities Act for derivatives transactions between Qualified Parties and Commercial Users. However the requirements for registration with the OSC should continue for persons who advise on those derivatives transactions.

Disclosure

Risk disclosure

Commodity Futures Contracts and Commodity Futures Options

The Commodity Futures Act obliges every dealer and adviser to give each prospective client, irrespective of their sophistication, a risk disclosure statement prior to opening an account.⁴³⁷ The Regulations set out separate

⁴³⁶ Securities Act Regulation Pt V; Commodity Futures Act Regulation Pt III.

⁴³⁷ Section 40 provides:

- "Every registered dealer or adviser shall furnish each prospective customer prior to the opening of an account with a written statement in the form prescribed under the regulations which will,
- (a) explain the nature of, and risks inherent in trading in contracts and obligations assumed by the customer upon entering a contract:
 - (b) advise the client to request and study the terms and conditions of the contract:
and

forms for commodity futures contracts and commodity futures options.⁴³⁸ In practice, dealers and advisers customise the prescribed forms. The Ontario Securities Commission permits customised forms, provided they include the mandatory disclosures.

Options under the Securities Act

The OSC has ruled, under RORO, that trades in "recognized options", cleared through "recognized clearing organizations", are not subject to the Securities Act's registration and prospectus provisions, provided that the dealer has given the investor a standardised risk disclosure statement before trading.⁴³⁹ In summary, the risk disclosure statement describes:

- . the nature of an option
- . the specifications of options
- . the exercise of options
- . trading of options
- . costs of options trading
- . risks of options trading.

In addition, RORO:

- . imposes the obligation to provide the risk disclosure statement on both dealers and advisers
- . requires that the risk disclosure statement be delivered to the client or sent by prepaid mail
- . requires that the risk disclosure statement be sent to all clients regardless of sophistication.

OTCs

The OSC's Draft Interpretation on OTC derivatives proposes to exclude certain types of OTC transactions⁴⁴⁰ involving sophisticated participants from

-
- (c) furnish details concerning commissions and other charges levied by the dealer or adviser."

⁴³⁸ Forms 14 and 15 respectively.

⁴³⁹ For the OSC's power to grant this exemption, see Securities Act ss 74 and 144.

⁴⁴⁰ Transactions involving OTC derivative instruments in which the underlying interest or interests:

- . consists entirely of interest rates, currencies or foreign exchange rates or some combination thereof and

Securities Act regulation. The Draft Ruling deals with residual OTC derivatives, that is, those not excluded by the Draft Interpretation. It provides relief from the registration and prospectus requirements of the Securities Act for some residual OTC derivatives being:

- all residual OTC derivatives transactions where all the parties are either Qualified Parties⁴⁴¹ or Commercial Users⁴⁴²
- all other residual OTC derivative transactions, where the transaction is effected through a broker/dealer who gives a risk disclosure statement to the retail party.

The risk disclosure statement required for the latter category of transactions is set out in the second schedule to the Draft Ruling. The statement briefly describes:

- the effect of leverage in OTC transactions
- risk reducing strategies
- the variable degrees of risk for OTC options
- terms and conditions of contracts
- liquidity and restrictions of pricing relationships
- credit risk
- commissions and other charges
- transactions in other jurisdictions
- currency risks
- legal risks
- management risks
- tax risks.

There is no requirement in the Draft Ruling that clients sign or acknowledge their understanding of the risks disclosed.

• includes as a material component commodities or commodity prices.

⁴⁴¹ Qualified Parties include certain banks, credit unions, insurance companies and individuals with a net worth of CN\$5 million (excluding their principal residence).

⁴⁴² A Commercial User is defined as "an entity which uses the commodity which underlies the derivative in its business for risk management, as opposed to speculation". The Ontario Securities Commission Report states that determining whether a transaction was entered into for risk management rather than speculation would be drawn from the surrounding circumstances.

The Exchange Rules

The By-laws of The Toronto Stock Exchange and The Toronto Futures Exchange require that all clients be given a risk disclosure statement (a Futures Contract Information Statement or Futures Contract Option Summary Disclosure Statement) before trading commodity futures contracts or options.⁴⁴³ In each case the exchange member must obtain from the client a written acknowledgment of receipt of the statement.⁴⁴⁴

Customer agreements

Unlike s 1210 of the Australian Corporations Law, the Securities Act and the Commodity Futures Act are silent about customer agreements. However, The Toronto Stock Exchange and The Toronto Futures Exchange By-Laws require members to enter into trading agreements with their clients.⁴⁴⁵ Further, the By-laws prescribe the minimum contents of such agreements and require the client's signature.⁴⁴⁶ There are no pro forma agreements. The prescribed terms deal with various matters including:

- the extent of the discretion to be exercised by the member
- imposition of trading limits and the member's right to close out
- determination of margin calls by the member
- member's rights in respect of raising money on and pledging assets in the client's account
- the extent of the member's other rights to deal with assets in the client's account and to hold them as collateral for the client's indebtedness
- the extent of the member's right to utilise securities in the client's account for the member's purposes
- the member's right to transfer funds between accounts where there is more than one client account
- the client's acknowledgment of receiving the risk disclosure statement.

⁴⁴³ TSE By-Laws 24.15, 25.15; TFE By-Laws 9.04, 9.18.

⁴⁴⁴ Ibid.

⁴⁴⁵ TSE By-Laws 24.16, 25.16; TFE By-Laws 9.05, 9.19.

⁴⁴⁶ TSE By-Laws 24.17, 25.17; TFE By-Laws 9.06, 9.20.

Prospectus disclosure

All derivatives other than those regulated under the Commodity Futures Act are currently regulated under the Securities Act. The OSC may grant complete or conditional exemptions from the prospectus requirements if satisfied that this would not prejudice the public interest.⁴⁴⁷ These "Rulings" have often been applied to derivative securities, particularly to options (see RORO). The proposed regime for the regulation of OTC transactions is based on providing an exemption from the registration and prospectus provisions.⁴⁴⁸ All other derivative securities (of which there are a limited number) are subject to the prospectus requirements of the Securities Act.

Fees and benefits

Fees are not generally regulated under the Commodity Futures Act or the Securities Act. However, there are some restrictions on the method for determining fees, for instance prohibitions on performance-based fees for managed accounts without client agreement.⁴⁴⁹

Suitability

Statutory requirements

The Securities Act⁴⁵⁰ and the Commodity Futures Act⁴⁵¹ both impose suitability requirements on dealers and advisers. RORO does not impose such

⁴⁴⁷ Securities Act ss 74, 144.

⁴⁴⁸ *Over-the-Counter Derivatives in Ontario - An OSC Staff Report and Draft Policy Statement* (1994).

⁴⁴⁹ TSE By-Laws 24.24, 25.24; TFE By-Laws 9.13, 9.27.

⁴⁵⁰ Section 114 of the Regulation under the Securities Act provides that:

- (1) Every registered dealer and adviser shall establish procedures for dealing with its clients that conform with prudent business practice and that enable it to service its clients adequately and shall take whatever steps are necessary or appropriate to supervise such procedures properly.
- (4) For the purposes of subsection (1).....each dealer, investment counsel, and portfolio manager shall make such enquires as,
 - (a) will enable it to establish the identity, and where applicable, the creditworthiness of each client, and the reputation of the client if information known to the dealer, investment counsel, or portfolio manager, causes doubt as to whether the client is of good reputation; and
 - (b) are appropriate in view of the nature of the client's investment and of the type of transactions being effected for its account, as to the general

a requirement. However, to the extent that registrants under the Securities Act and the Commodity Futures Act deal in or advise on "recognized options" pursuant to RORO, the suitability requirement under those Acts applies.

There is a continuing suitability obligation for commodity futures contracts and commodity futures options but not for options regulated under the Securities Act.⁴⁵²

The Exchange Rules

The By-Laws of The Toronto Stock Exchange and The Toronto Futures Exchange impose a suitability requirement similar to that under the Commodity Futures Act, including the obligation to ensure continuing suitability.⁴⁵³ The continuing suitability obligation is reinforced by other By-Laws which oblige a member to use due diligence to ensure that prior to entering any futures order:

investment needs and objectives of each client and the suitability of a proposed purchase or sale for that client.

- ⁴⁵¹ Section 28 of the Regulation made under the Commodity Futures Act provides:
- (1) Each registrant that is a dealer, commodity trading counsel or commodity trading manager shall, before accepting the account of a customer, make enquires that,
 - (a) will enable the registrant to establish the identity of the customer and, where appropriate,
 - (i) the creditworthiness of the customer, in accordance with guidelines established by the registrant, and
 - (ii) the reputation of the customer, if information known to the registrant causes doubt whether the customer is of good reputation; and
 - (b) will enable the registrant to assess the suitability of trading by the customer in view of the markets in which the customer intends to trade, the scale of trading the customer intends to undertake, and the general objectives of the customer.
 - (2) Every dealer, commodity trading counsel and commodity trading manager shall, as frequently as is appropriate in view of the particular financial circumstances of the customer, obtain, by direct enquiries of the customer or by other means, information enabling the dealer, counsel or manager to determine whether the assessment under clause (1)(b) of the suitability of trading continues to be accurate.

Note: There is no equivalent to subsection 28(2) in the regulations under the Securities Act.

⁴⁵² Ibid.

⁴⁵³ TSE By-Laws 24.13, 25.13; TFE By-Laws 9.02, 9.16.

- the acceptance of every order is within the bounds of good business practice and
- trades made for any account are appropriate for the client and in keeping with the client's financial objectives.⁴⁵⁴

There are some exceptions to this requirement, for instance where the client is a fellow member.⁴⁵⁵

Commodity Pool Programs

OSC Policy 11.4 imposes a suitability requirement for investors in commodity pool Programs (mutual funds established solely for the purpose of trading in derivatives). Suitability standards must be set out in both the prospectus and written subscription forms to be executed by the investor. The prospectus must include the investment objectives of the program and a description of the type of investor who could benefit from the program.⁴⁵⁶

⁴⁵⁴ TSE By-Laws 24.19, 25.19; TFE By-Laws 9.08, 9.22.

⁴⁵⁵ Ibid.

⁴⁵⁶ Part D of OSC Policy 11.4 provides that:

- "1. The Program dealer shall make every reasonable effort to ensure that interests are offered or sold only to potential Participants for whom the investment is appropriate in light of the Program suitability standards set forth in the prospectus as required and each potential participant's investment objectives and financial situation.
2. The Program dealer shall determine that:
 - (a) The potential participant has the capacity of understanding the fundamental aspects of the Program, which capacity may be adduced from the following:
 - (1) nature of employment experience;
 - (2) educational level achieved;
 - (3) access to advice from qualified sources, such as legal, accounting and tax advisory;
 - (4) prior experience with investments of a similar nature.
 - (b) The potential participant apparently understands the following aspects of the Program being sold:
 - (1) the fundamental risks and possible financial hazards of the investment;
 - (2) the lack of liquidity of the investment;
 - (3) management and control by the promoters;
 - (4) the tax consequences of the investment.
 - (c) The potential participant can bear the economic risk of the investment; for purposes of determining the ability to bear the economic risk, unless the Commission approves a lower suitability standard, participants should have a minimum annual gross income of CN\$30,000 and a net worth of CN\$30,000, or, in the alternative, a net worth of CN\$75,000 in high-risk offerings, higher suitability standards may be required."

Financial supervision

Capital Requirements

All dealers registered by the OSC under the Securities Act or the Commodity Futures Act must meet stipulated capital requirements, set out in the Joint Regulatory Financial Questionnaire and Report (the JRFQR), prepared by various Canadian SROs. It establishes a liquidity test that determines whether a firm has sufficient capital to meet its current liabilities.

Clearing members must, at all times, meet the minimum requirements of the Canadian clearing house, Trans Canada Options Inc, and those of the participating exchanges to which they belong. If the capital requirements of the clearing house and the participating exchange are not uniform, the clearing member must adhere to the more stringent requirements. The clearing house rules also provide that no exchange-traded option or futures transaction shall be cleared for any clearing member who does not meet the prescribed capital requirements.

Advisers under the Securities Act and the Commodity Futures Act must meet the capital requirements in the regulations.⁴⁵⁷

Canada has implemented the International Basle Accord on capital requirements for dealers in swaps and equivalent instruments. The regulator of Canadian banks, the federal Office of the Superintendent of Financial Institutions, has published a Guideline requiring Canadian banks to maintain capital equal to at least eight per cent of all risk-weighted assets and risk-weighted off-balance sheet items such as derivatives.

Financial compliance programs

The SROs carry out continuous surveillance. They receive audited financial statements annually from their members. The key financial filing is the monthly JRFQR.

⁴⁵⁷ The Securities Act and Commodity Futures Act regulations provide that every adviser must, unless otherwise provided, maintain a minimum free capital of the maximum amount, if any, that is deductible under any clause of a specified insurance policy, plus CN\$5,000 in working capital or such greater amount as the OSC considers necessary where the adviser exercises control over the client's money.

Auditors, appointed by the SROs and approved by the OSC, have unconditional access to all books and records of dealers.

Trans Canada Options Inc may also require its auditor to examine the affairs of a clearing member.

Advisers are not subject to financial compliance programs other than filing annual audited financial statements with the OSC. However, the OSC may, at any time, order an audit of the adviser's financial affairs.

Advertising

The OSC has power under the Securities Act to review advertising and sales literature to be issued by registrants.⁴⁵⁸ Under the Commodity Futures Act, the OSC may review this literature if issued by dealers.⁴⁵⁹ The OSC has no direct power to review the literature of futures advisers but, if necessary, may suspend the registration of an adviser under the Commodity Futures Act.

The By-Laws of The Toronto Stock Exchange, The Toronto Futures Exchange and the Investment Dealers Association of Canada require that all advertisements and sales literature issued by a member be approved by designated persons under the rules.⁴⁶⁰

Transaction reporting

Securities Act⁴⁶¹ and Commodity Futures Act⁴⁶² registrants must maintain specified records of all transactions whether on or off-exchange. In addition, The Toronto Futures Exchange and The Toronto Stock Exchange have detailed By-laws to regulate the content of client records.⁴⁶³

⁴⁵⁸ s 46.

⁴⁵⁹ s 54.

⁴⁶⁰ TSE By-Law 16.35; TFE By-Law 4.03.

⁴⁶¹ Securities Act s 21; Securities Act Regulation s 113.

⁴⁶² Commodity Futures Act s 18; Commodity Futures Act Regulation s 15.

⁴⁶³ TFE By-Law 9.70; TSE By-Law 16.13.

Protection of client money

Under the Commodity Futures Act⁴⁶⁴ and Securities Act⁴⁶⁵ client funds must, unless exempt, be segregated. The majority of dealers registered under the Commodity Futures Act are exempt from this requirement.

The Securities Act regulations provide the conditions under which a registrant must, or in some cases may, transfer a credit balance from a securities account to a commodity futures account of the same client to reduce a debit balance in the latter.⁴⁶⁶ The OSC may exempt registrants who are members of The Toronto Stock Exchange or the Investment Dealers Association where it is satisfied that the registrant is subject to requirements imposed by one or both of the SROs that provide protection for clients at least equal to that under the regulations.⁴⁶⁷

With limited exceptions, all portfolio securities of a Commodity Pool Program fund must be held by a Custodian (a defined term) which meets the guidelines in National Policy 39.

Compensation funds

The Securities Act regulations require every dealer, other than a security issuer, to participate in a compensation fund or a contingency trust fund approved by the OSC.⁴⁶⁸ The OSC may vary the amount required to be contributed.⁴⁶⁹ Members of The Toronto Stock Exchange and the Investment Dealers Association must contribute to the Canadian Investors Protection Fund (CIPF) which provides compensation where a dealer has become bankrupt or insolvent.

Advisers under the Securities Act are not obliged to contribute to a compensation fund but they must maintain insurance.⁴⁷⁰

⁴⁶⁴ Commodity Futures Act s 46; Commodity Futures Act Regulation s 35.

⁴⁶⁵ Securities Act Regulation s 116.

⁴⁶⁶ Securities Act Regulation s 120.

⁴⁶⁷ Securities Act Regulation s 122.

⁴⁶⁸ Securities Act Regulation s 110(1).

⁴⁶⁹ Securities Act Regulation s 110(2).

⁴⁷⁰ Securities Act Regulation s 108(3).

Dealers registered under the Commodity Futures Act must be dealer members of The Toronto Futures Exchange, which has its own contingency fund.

Customers of a dealer member of the TFE may also enjoy the protection afforded by the CIPF. For advisers under the Commodity Futures Act, clients' assets which are subject to trading recommendations must be held by dealers registered under the Commodity Futures Act and are therefore subject to CIPF protection.

Further, the SROs require dealers to maintain insurance to cover misappropriation and fraud.

There is no specific customer funds protection for investors in commodity pool Programs. However, intermediaries who sell units in these Programs must be members of an SRO.⁴⁷¹ Customers therefore have the benefit of CIPF protection.

Gaming and wagering legislation

It is unclear whether certain kinds of transactions offend gaming and wagering laws. The case law supports the position that transactions effected for a legitimate business purpose do not breach the legislation.⁴⁷²

Netting

The validity of netting provisions has been expressly recognised by the Canada Deposit Insurance Corporation Act. The liquidation provisions of the Bankruptcy and Insolvency Act and the Winding-Up Act do not expressly recognise netting provisions. However, they each provide for setting off mutual debts upon liquidation.

⁴⁷¹ OSC Policy 11.4 Pt B.

⁴⁷² Group of Thirty Report, Appendix II, Opinion of Stikeman Elliott at 141.

CHAPTER 5. UNITED STATES OF AMERICA

Scope of regulation

Regulatory overview

Regulation of derivatives in the United States is divided between the Commodity Futures Trading Commission (CFTC) and the Securities and Exchange Commission (SEC).

The SEC regulates derivatives that are securities, options on securities and any index over securities but not futures contracts over any of these.

The CFTC regulates:

- permitted futures contracts over securities⁴⁷³
- permitted futures contracts over a share index⁴⁷⁴
- financial futures and financial futures options
- commodity futures and commodity futures options
- commodity options.⁴⁷⁵

The CFTC may ban, or impose conditions on, trading in commodity options.⁴⁷⁶ It has banned most OTC commodity options.⁴⁷⁷ On-exchange trading of commodity options is permitted.⁴⁷⁸

⁴⁷³ These are limited to futures contracts over certain securities such as government or bank securities, for instance, the 30-year Treasury Bond futures contract on the Chicago Board of Trade. Futures contracts over the shares of particular companies are prohibited outright: Commodity Exchange Act s 2(a)(1)(B)(v).

⁴⁷⁴ A future over a share index and options on those futures are only permitted if:

- the index is broadly based
- the contract is cash settled or settled otherwise than by delivery of a security (unless the security is one of those referred to in note 473) and
- the contract is not readily susceptible to price manipulation (Commodity Exchange Act s 2(a)(1)(B)(ii)).

⁴⁷⁵ Commodity Exchange Act s 4c(b).

⁴⁷⁶ Ibid.

⁴⁷⁷ It has prohibited OTC commodity options over certain agricultural commodities: Commodity Exchange Act reg 32.2. The CFTC also currently prohibits over the counter trading of other commodity options (reg 32.11) except for:

- dealer options (s 4c(d), reg 32.12)
- "trade" options (reg 32.4(a))
- approved foreign options (reg 30.3(a)).

The CFTC may exempt from its regulation derivatives that involve only sophisticated parties (such as banks, insurance companies and large corporations).⁴⁷⁹ The CFTC has used this power to exempt specified swaps,⁴⁸⁰

"Dealer options" are options to buy or sell physical commodities where the grantor is in the business of buying, selling, producing, or otherwise dealing in the underlying commodity and satisfies certain other criteria: see Commodity Exchange Act s 4c(d), Johnson & Hazen, supra note 1 vol I at 27-28, vol II at 45-47, 48-54. No dealer options are currently used.

"Trade" options are options where the person being offered the option deals in the business on which the commodity is based. Commodity Exchange Act reg 32.4 provides that the person offering the option must have "a reasonable basis to believe that the option is offered to a producer, processor, or commercial user of, or a merchant handling, the commodity which is the subject of the commodity option transaction, or the products or byproducts thereof, and that such producer, processor, commercial user or merchant is offered or enters into the commodity option transaction solely for purposes related to its business as such".

478 Commodity Exchange Act Regulations Pt 33.

479 Commodity Exchange Act s 4(c).

480 Commodity Exchange Act Regulations Pt 35. The exemption applies if:

- the agreements are entered into between eligible swap participants (institutions and individuals with a high net worth, broker-dealers and futures commission merchants: see reg 35.1(b)(2) definition of "eligible swap participant")
- the swap agreement "is not part of a fungible class of agreements that are standardised as to their material economic terms"
- creditworthiness of the parties is relevant to entering into the agreement
- the agreement "is not entered into and traded on or through a multilateral execution facility".

The exemption provides that the second and fourth of these factors are not to be taken to prohibit netting.

The definition of swap agreement for the purpose of the swaps exemption is that in s 101 of Title 11 of the United States Code (Bankruptcy) (Commodity Exchange Act s 4(c)(5)(B)):

"swap agreement" means--

- (A) an agreement (including terms and conditions incorporated by reference therein) which is a rate swap agreement, basis swap, forward rate agreement, commodity swap, interest rate option, forward foreign exchange agreement, rate cap agreement, rate floor agreement, rate collar agreement, currency swap agreement, cross-currency rate swap agreement, currency option, any other similar agreement (including any option to enter into any of the foregoing);
- (B) any combination of the foregoing; or
- (C) a master agreement for any of the foregoing together with all supplements.

although these remain subject to fraudulent trading and price manipulation provisions.⁴⁸¹

The CFTC has also exempted from its regulation all hybrid instruments⁴⁸² that are supervised by another regulator whether or not they involve sophisticated parties.⁴⁸³ In addition, the CFTC has exempted from its regulation certain energy contracts.⁴⁸⁴

The CFTC has no jurisdiction over certain financial transactions (for instance, foreign currency transactions and transactions in government securities) unless transacted as on-market futures contracts (the "Treasury amendment").⁴⁸⁵ The SEC has no jurisdiction over any of these transactions.

Role of SROs

Self-regulatory organisations, which are supervised by the CFTC or the SEC, are involved in regulating derivatives.

SROs supervised by CFTC

These are exchanges or boards of trade⁴⁸⁶ and futures associations.

⁴⁸¹ Commodity Exchange Act ss 4b and 4o (see reg 35.2). The CFTC has not pronounced on whether the Commodity Exchange Act would apply to swaps if there were no exemption. However, in October 1994, the CFTC sought public comment on whether it should establish anti-fraud and anti-manipulation rules devoted exclusively to swaps: 59 Fed. Reg. 54,139 at 54,150 (28 October 1994).

⁴⁸² Hybrids combine equity or debt securities or depository interests with features of commodity futures or commodity option contracts or both.

⁴⁸³ Commodity Exchange Act Regulations Pt 34.

⁴⁸⁴ The exemption applies to energy contracts having features similar to forward contracts for designated categories of persons: CCH Commodity Futures Law Reporter [1992-94] para 25,633.

⁴⁸⁵ Commodity Exchange Act s 2(a)(1)(A)(ii). For a discussion of whether the Treasury amendment applies where transactions involving the general public are concerned, see JT Medero, "Jurisdictional Issues in US Regulation of Derivative Products", (1994) 9 *Butterworths Journal of International Banking and Financial Law* 117 at 119, and "CFTC v Dunn/Delta: Treasury Amendment Redux", November/December 1994 Vol XIV Nos 9 & 10 *Futures International Law Letter* 1. The US courts have taken differing views on whether the Treasury Amendment applies to options over the specified transactions: Medero, "CFTC v Dunn/Delta: Treasury Amendment Redux" at 3, 4-5.

⁴⁸⁶ Some United States exchanges are referred to as boards of trade. "Board of trade" is defined in the Commodity Exchange Act as "any exchange or association, whether

Exchanges

The exchanges regulate derivatives primarily through their membership requirements (including capital and other financial obligations), audit and financial surveillance of members and their surveillance and disciplinary powers.⁴⁸⁷ The exchanges must have arbitration procedures for resolving disputes with clients.⁴⁸⁸

The CFTC may:

- alter or supplement exchange rules, but not those setting margin levels except on stock index futures⁴⁸⁹
- require exchange surveillance programmes⁴⁹⁰
- review disciplinary actions and membership decisions of an exchange and if necessary take disciplinary action itself⁴⁹¹
- review other exchange actions on application by any person adversely affected⁴⁹²

incorporated or unincorporated, of persons who are engaged in the business of buying or selling any commodity or receiving the same for sale on consignment": s 1a(1). However, US courts have generally assumed that the expression is synonymous with "organised exchange": JT Medero, "CFTC v Dunn/Delta: Treasury Amendment Redux", November/December 1994 Vol XIV Nos 9 & 10 *Futures International Law Letter* 1 at 4, note 26. A board of trade must be designated as a "contract market" for each type of futures contract which it proposes to trade: Commodity Exchange Act s 4(a). A single board of trade or exchange may therefore be a number of contract markets equal to the number of types of futures contracts for which the CFTC has given it approval to trade, although the term "contract market" is often used to refer to a board of trade or exchange that has one or more CFTC designations: Johnson & Hazen, *supra* note 1 vol I at 85-86. The CFTC's power to designate a board of trade as a "contract market" is in s 5 of the Commodity Exchange Act.

⁴⁸⁷ Commodity Exchange Act ss 5, 5a, 8c; regs 1.51, 1.52, 1.53, 1.54. See also CFTC Guideline No 2 (Contract Market Rule Enforcement Program), CCH Commodity Futures Law Reporter para 6,430.

⁴⁸⁸ Commodity Exchange Act s 5a(a)(11).

⁴⁸⁹ Commodity Exchange Act s 8a(7) (there is also a specific rule allowing the CFTC to alter rules relating to delivery of commodities: s 5a(a)(10)). The power to set margin levels on stock index futures was given to the Federal Reserve Board in 1992 under s 2(a)(1)(B)(vi)(II) of the Commodity Exchange Act. The Board delegated the power to the CFTC under s 2(a)(1)(B)(vi)(III).

⁴⁹⁰ Commodity Exchange Act regs 1.51, 1.52.

⁴⁹¹ Commodity Exchange Act s 8c(b).

⁴⁹² *Id.*

- discipline an exchange⁴⁹³ or a member of the board of an exchange.⁴⁹⁴

In addition, the Commission has "emergency" intervention powers to maintain or restore orderly trading. These cover threatened or actual market manipulation or other activity which prevents the market from accurately reflecting supply and demand.⁴⁹⁵

Futures associations

The CFTC has supervisory power over the rules and activities of futures associations. It can register associations, review their disciplinary proceedings and abrogate their rules under certain conditions.⁴⁹⁶ Their rules must, among other things:

- promote just and equitable principles of trade
- set membership proficiency standards
- provide for disciplining members for violation of association rules
- provide procedures for resolving disputes.⁴⁹⁷

The only registered association is the National Futures Association.

SROs supervised by SEC

Self-regulatory organisations governed by the SEC are:

- securities exchanges
- securities associations.

To practise, a person must be registered with the SEC and be a member of one or more securities exchanges or join the National Association of Securities Dealers. All brokers and dealers dealing in derivative securities must also be members of the Securities Investor Protection Corporation, unless

⁴⁹³ The CFTC may suspend an exchange for up to six months or revoke its designation as a contract market if it fails or refuses to comply with the Commodity Exchange Act or the rules, regulations or orders of the CFTC: Commodity Exchange Act s 5b.

⁴⁹⁴ Commodity Exchange Act s 8e.

⁴⁹⁵ Commodity Exchange Act s 8a(9).

⁴⁹⁶ Commodity Exchange Act s 17(c), (j), (k) (rules), s 17(h), (i) (disciplinary proceedings).

⁴⁹⁷ Commodity Exchange Act s 17.

their principal business is conducted outside the United States or they are insurance or investment company brokers or dealers.⁴⁹⁸

Securities exchanges and securities associations have primary responsibility for disciplining their members.⁴⁹⁹ The SEC may supervise these disciplinary programmes.⁵⁰⁰ The rules of securities exchanges and associations must promote just and equitable principles of trade⁵⁰¹ and set membership standards.⁵⁰² The rules and any changes to these rules must be approved by the SEC.⁵⁰³ The SEC may abrogate, add to or delete from SRO rules.⁵⁰⁴

The securities option exchanges operate the Options Clearing Corporation (OCC). This clearing organisation monitors its members to protect against loss arising from default or insolvency of a member and to identify options positions that pose unwarranted risk to the clearing member and OCC.

Content of regulation

Exchange-trading requirement

Derivatives regulated by the CFTC

Off-exchange trading in futures transactions regulated under the Commodity Exchange Act is generally prohibited⁵⁰⁵ except for forwards⁵⁰⁶ (which remain subject to the fraudulent trading⁵⁰⁷ and market manipulation provisions⁵⁰⁸) or unless the CFTC grants an exemption to permit it.⁵⁰⁹

⁴⁹⁸ Securities Investor Protection Act 1970 s 3(a)(2)(A).

⁴⁹⁹ Securities Exchange Act ss 6(b)(6), 15A(b)(7), (8).

⁵⁰⁰ Securities Exchange Act s 19(e).

⁵⁰¹ Securities Exchange Act ss 6(b)(5), 15A(b)(6).

⁵⁰² Securities Exchange Act ss 6(c)(3), 15A(g)(3).

⁵⁰³ Securities Exchange Act s 19(a), 19(b).

⁵⁰⁴ Securities Exchange Act s 19(c).

⁵⁰⁵ Commodity Exchange Act s 4(a).

⁵⁰⁶ The off-exchange trading prohibition in s 4(a) of the Commodity Exchange Act refers to "a contract for the purchase or sale of a commodity for future delivery". Section 1a(11) provides that future delivery "does not include any sale of any cash commodity for deferred shipment or delivery".

⁵⁰⁷ For instance, the prohibition on fraudulent trading and misrepresentation by commodity trading advisors, commodity pool operators and associated persons in s 4o of the Commodity Exchange Act is not expressed in terms of a contract for future delivery. The CFTC's exemption for energy contracts, which are like forward

The rules governing futures exchange-based dealing do not distinguish between sophisticated and non-sophisticated parties.

Derivatives regulated by the SEC

Options may be traded OTC or quoted on an exchange.

The rules governing securities exchange-based dealing do not distinguish between sophisticated and non-sophisticated parties.

Retail OTC transactions

Retail participants may enter into certain OTC transactions. They may trade in OTC forward contracts.⁵¹⁰ Also, the CFTC does not prohibit retail trading in those "hybrid instruments" which are otherwise regulated under any applicable securities or banking laws.⁵¹¹ It is also arguable that some transactions within the "Treasury amendment" (for instance, foreign currency transactions and transactions in government securities) may be traded OTC by retail participants.⁵¹²

Licensing

The CFTC and the SEC license persons as intermediaries.⁵¹³ These administrative agencies and the SROs are involved in the ongoing regulation and surveillance of licensees.

contracts, included an exemption from the anti-fraud rules: CCH Commodity Futures Law Reporter [1992-94] para 25,633.

508 The CFTC's energy exemption did not include an exemption from the price manipulation provisions of s 9(a)(2) of the Commodity Exchange Act: *ibid*.

509 Commodity Exchange Act s 4(c)(1). The CFTC's power to exempt is discussed *supra* at 121-122.

510 *Supra* note 506.

511 CCH Commodity Futures Law Reporter [1992-94] para 25,538 (22 January, 1993).

512 Medero, *supra* note 485.

513 The CFTC licenses futures commission merchants and introducing brokers (Commodity Exchange Act s 4d), persons who are associated with futures commission merchants and introducing brokers and who solicit or accept customers' orders (s 4k), floor brokers and floor traders (s 4e) and commodity trading advisers and commodity pool operators (s 4m). There are specific exemptions from the requirement to be licensed as a commodity trading advisor, for instance for lawyers and reporters: s 1a(5)(B)(ii). Futures commission merchants and floor brokers also do not need to be separately licensed as commodity trading advisors: s 1a(5)(B)(iii).

Intermediaries subject to CFTC or SEC jurisdiction must meet some or all of the following:⁵¹⁴

- minimum financial requirements⁵¹⁵
- record keeping requirements⁵¹⁶
- client fund segregation requirements⁵¹⁷
- requirements to report material inadequacies in internal controls to the relevant regulator.⁵¹⁸

Disclosure

Risk disclosure

Derivatives within CFTC jurisdiction

The legislation imposes risk disclosure requirements on licensees before acting on behalf of their clients. The form of risk disclosure depends on the type of derivative being traded and the person providing the statement. The types of derivatives risk disclosure statement are:

- an FCM statement⁵¹⁹

The CFTC has authorised the National Futures Association to perform certain administrative licensing functions: Commodity Exchange Act reg 3.2. The SEC licenses securities brokers and dealers: Securities Exchange Act s 15.

⁵¹⁴ Regulatory requirements applicable to each type of CFTC registrant are discussed at Johnson & Hazen, *supra* note 1 vol I at 119-213.

⁵¹⁵ Commodity Exchange Act reg 1.17 (futures commission merchants and introducing brokers); Securities Exchange Act reg 15c3-1(a)(2).

⁵¹⁶ Commodity Exchange Act s 4g, regs 1.31 to 1.37; Securities Exchange Act s 17(a)(1), reg 17a-3.

⁵¹⁷ Commodity Exchange Act s 4d; Securities Exchange Act reg 15c3-3.

⁵¹⁸ Commodity Exchange Act reg 1.16; Securities Exchange Act reg 17a-5(j).

⁵¹⁹ This is a statement given by a futures commission merchant or an introducing broker before opening a commodity futures account for a customer (Commodity Exchange Act reg 1.55). The reg 1.55 requirements must also be complied with by futures commission merchants and introducing brokers opening foreign futures and options accounts for foreign futures or options customers and by commodity trading advisors directing or guiding a client's foreign commodity interest trading: reg 30.6(a), (b). Associated persons of futures commission merchants and introducing brokers are also subject to the disclosure obligations applicable to their principals: Johnson & Hazen, *supra* note 1, 1994 supplement to Second Edition vol II at 61 (addition to para 3.107 vol II at 162).

- an on-exchange option statement⁵²⁰

⁵²⁰ This is a statement given to an options customer by a futures commission merchant or an introducing broker before opening an account relating to commodity options traded on a United States exchange (Commodity Exchange Act reg 33.7).

- an off-exchange option statement⁵²¹
- a CTA statement.⁵²²

In general, the client must provide written acknowledgement of having received the disclosure document and, in some instances, an acknowledgement of having understood it.⁵²³

There is no risk disclosure requirement for hybrids⁵²⁴ or exempt swaps.

The Generic Risk Disclosure Statement for Futures and Options agreed between the CFTC, the UK Securities and Futures Authority and the Central Bank of Ireland may be given instead of the FCM statement and the on-exchange option statement.⁵²⁵

⁵²¹ This is a statement given to an options customer or prospective options customer by a person soliciting or accepting an order for a commodity option transaction that is not executed on an exchange (Commodity Exchange Act reg 32.5).

⁵²² This is a statement given by a commodity trading advisor who seeks to acquire control of any client's account (that is, a right to enter trades without the client's specific authorisation or pursuant to a systematic advisory programme that recommends specific transactions) (Commodity Exchange Act reg 4.31). The FCM, on-exchange option and CTA statements are prescribed in the regulations. Part of the off-exchange option statement is similarly prescribed, but the wording of other elements to be included is left to the person preparing the statement. Commodity pool operators must give a disclosure statement setting out the risks of participating in a commodity pool: Commodity Exchange Act reg 4.21. In addition to these risk disclosure statements, a futures commission merchant must give a statement to customers depositing non-cash margin disclosing that customer property will be distributed pro rata in the case of the FCM's bankruptcy (Commodity Exchange Act reg 190.10).

⁵²³ An FCM or introducing broker may not enter into a commodity futures or on-exchange option transaction before receiving a signed and dated acknowledgement that the customer has received and understood the risk disclosure statement: Commodity Exchange Act regs 1.55(a)(1)(ii), 33.7(a)(1)(ii). A commodity trading advisor may not enter into an agreement with a customer to direct the customer's commodity interest account or guide the customer's commodity interest trading without receiving a signed and dated acknowledgement that the customer received the disclosure document: reg 4.31(d). There is no requirement for a person giving an off-exchange option statement to receive an acknowledgement from the customer.

⁵²⁴ However, a hybrid which is an equity or debt security is subject to the prospectus requirements of the Securities Act unless exempted under that Act.

⁵²⁵ Commodity Exchange Act reg 1.55(c), Appendix A.

FCM statement. The information in FCM statements covers:

- the risk of loss in futures trading, including possible loss of any margin and possible liability additional to margin calls
- possible difficulty in liquidating a position or limiting losses.

Additional warnings about possible differences in regulatory protection and the currency exchange risks must be given for trading in foreign futures or option contracts.

The Generic Risk Disclosure Statement for Futures and Options agreed between the CFTC, the UK Securities and Futures Authority and the Central Bank of Ireland may be given instead of the FCM statement.⁵²⁶

On-exchange option statement. This statement must be given to commodity option customers even if they have already received the FCM statement. The on-exchange option statement gives information about:

- trading commodity options on a United States exchange (including the risks)
- possible large financial loss and possible obligations of grantors of commodity options to provide margin
- realisation of profit on an option by exercise of the option or close out.

Futures commission merchants and introducing brokers are not considered to be option customers and need not be sent an on-exchange option statement.⁵²⁷

The Generic Risk Disclosure Statement may be given instead of the on-exchange option statement.

Off-exchange option statement. This statement requires disclosure of:

- the risks of options trading, including loss of the purchase price
- details of the commodity option transactions being offered including costs of exercising them
- the effect of foreign currency fluctuations on the transaction, if any.⁵²⁸

⁵²⁶ Commodity Exchange Act reg 1.55(c), Appendix A.

⁵²⁷ Commodity Exchange Act reg 33.7(g).

CTA statement. The CTA statement requires disclosure of:

- the risk of loss in futures trading and selling commodity options, including loss of margin and the possibility of liability additional to margin calls
- the risk of total loss of the premium and transaction costs for purchasers of commodity options
- possible difficulty in liquidating a position or limiting losses
- management and advisory fees.

The CFTC has exempted commodity trading advisors from the requirement to give a CTA statement in the case of certain sophisticated investors, known as qualified eligible clients.⁵²⁹

⁵²⁸ No off-exchange option statements are currently given. The three permitted types of off-exchange options are dealer options, trade options and approved foreign options (supra note 477). Dealer options are not currently traded. Trade options are exempted from the Commodity Exchange Act reg 32.5 requirement to give an off-exchange option statement: reg 32.4. The appropriate disclosure statement for approved foreign options is the FCM statement: reg 30.6(a).

⁵²⁹ This category includes futures commission merchants registered under the Commodity Exchange Act, broker-dealers registered under the Securities Exchange Act and commodity pool operators and commodity trading advisors registered and active for two years or who operate pools or provide commodity interest trading advice to commodity accounts which have total aggregate assets of more than US\$5 million. Qualified eligible client also includes, for instance:

- investment companies
- banks
- other savings institutions
- natural persons whose individual net worth, or joint net worth with the person's spouse, exceeds US\$1 million or whose income has exceeded US\$200,000 (or US\$300,000 taken together with the person's spouse) for the two previous years
- corporations, not formed for the purpose of opening an exempt account, with total assets exceeding US\$5 million
- governmental entities

if those persons also:

- own securities and other investments of at least US\$2 million
- have at least US\$200,000 in exchange-specified initial margin and option premium on deposit for their own account with a futures commission merchant at any time in the six months before opening the exempt account or
- own a portfolio consisting of percentages of the previous two items that add up to 100%: Commodity Exchange Act reg 4.7(b).

Other disclosure obligations. Futures commission merchants, introducing brokers, their associated persons and other commodity professionals have an ongoing duty to disclose to their customers material facts about commodity futures transactions, including the risks involved in the transactions, where the customer is relying on their expertise and judgment in either entering the market or making trading decisions.⁵³⁰

Also, all NFA members and associates must provide new customers with a risk disclosure statement before opening an account.⁵³¹

Derivatives within SEC jurisdiction

Brokers and dealers must have given clients a copy of the Options Disclosure Document prepared by the Options Clearing Corporation before accepting their order to purchase or sell an exchange-traded option or approving their account for trading the option.⁵³²

The information to be covered by the Options Disclosure Document includes:

- the mechanics of buying, writing and exercising the options, including settlement procedures
- the risks of trading the options
- the market for the options
- a brief reference to the transaction costs, margin requirements and tax consequences of options trading
- identification of the issuer of the options
- identification of the instrument or instruments underlying the options class
- the availability of the prospectus.

SROs may also require that members and member organisations give clients a written description of the risks involved in uncovered short options

This regulation also reduces the disclosure obligation for commodity pool operators. Commodity pool operators also have fewer disclosure obligations where the pool is offered or sold, or has an exemption, under the Securities Act 1933 and has a minimal involvement with futures contracts: reg 4.12(b).

⁵³⁰ Johnson & Hazen, *supra* note 1 vol III at 162-163, 165-167.

⁵³¹ National Futures Association Compliance Rule 2-30.

⁵³² Securities Exchange Act reg 9b-1. See also, for example, New York Stock Exchange rule 726(a), American Stock Exchange rule 926(a).

transactions, in addition to the Options Disclosure Document, at or prior to the client's initial uncovered short options transactions.⁵³³

Customer agreements

The CFTC has not prescribed any particular form of customer agreement. However, it requires that certain matters, where applicable, be set out in a customer agreement⁵³⁴ and identifies other matters that may be included in a customer agreement or other client documentation if relevant.⁵³⁵

Prospectus disclosure

There are no prospectus requirements for CFTC regulated futures. However, prospectus-type disclosure is required for most investments in commodity pools or before opening managed accounts with a commodity trading advisor.⁵³⁶

The prospectus provisions principally apply to primary issues of securities. A prospectus is required for privately issued options, whether or not they are later quoted on an exchange, unless a relevant SEC exemption applies, for

⁵³³ See, for example, New York Stock Exchange rule 721(e)5, American Stock Exchange rule 921(g)5.

⁵³⁴ For example, a customer's specific written consent to a transfer of the customer's account to another futures commission merchant after notice and right to instruct otherwise, to be valid, must be contained in the customer agreement: Commodity Exchange Act reg 1.65.

⁵³⁵ These include:

- written explanation of risks where premiums for options traded on foreign markets can be margined (CCH Commodity Futures Law Reporter [1990-92 Transfer Binder] para 24,806)
- written customer consent for a futures commission merchant to take the other side of the customer's trade (reg 155.3(b)(2))
- a written arbitration agreement which may not, however, exclude the customer's right to seek reparations under the Commodity Exchange Act (reg 180.3)
- written instructions of hedging customer whether positions should be liquidated without seeking further instructions if the futures commission merchant becomes bankrupt (reg 190.06(d)(1)).

⁵³⁶ Commodity Exchange Act regs 4.21 and 4.31. Information required to be disclosed includes the business backgrounds of the commodity pool operator's or commodity trading advisor's principals, the performance record of the commodity pool operator or commodity trading advisor and its principals and actual or potential conflicts of interest.

example, for accredited investors⁵³⁷ or foreign sales. Where the options are created by an exchange, the OCC Options Disclosure Document substitutes for a full prospectus.

Suitability

Neither the CFTC nor the SEC directly imposes suitability requirements.⁵³⁸ However, both the futures and securities SROs have developed "know your client" rules. The Federal Reserve has also agreed on suitability requirements for particular entities.⁵³⁹

The National Futures Association requires its members to seek from futures customers, who are individuals, financial and other relevant information including their annual income and net worth, and previous investment and futures trading experience.⁵⁴⁰ A customer may, by written waiver, decline to provide the information. There is no specific obligation to use this information to determine their client's suitability for futures trading.

⁵³⁷ Securities Act s 4(2), Regulation D. The categories of "accredited investor" cover sophisticated investors such as banks, insurance companies and persons with more than a stipulated net worth or annual income.

⁵³⁸ The CFTC considered but rejected a suitability requirement when it introduced the customer protection rules in Pt 166 of the Commodity Exchange Act Regulations: Johnson & Hazen, *supra* note 1 vol II at 158-159. Its reasoning was that a suitability rule would merely codify principles implied in the antifraud provisions of the Commodity Exchange Act. On the other hand, the Commission has not held that unsuitable transactions breach the antifraud provision in s 4b. Judicial views differ on whether a suitability requirement should be implied from the antifraud provisions of the Act: Johnson & Hazen vol III at 155-161 and 1994 supplement to Second Edition, vol III at 42-45. See also WC Greenough, "The Limits of the Suitability Doctrine in Commodity Futures Trading" (1992) 47 *The Business Lawyer* 991. The FCM statement and the CTA statement have what might be called a "reverse know your client" requirement which requires customers to consider carefully whether futures trading is suitable for them. Similarly, the on-exchange option statement and the off-exchange option statement warn customers that commodity options are not suitable for all members of the public.

⁵³⁹ In December 1994, Bankers Trust reached agreement with the Federal Reserve to ensure that each BT customer entering a leveraged derivatives transaction "has the capability to understand the nature and material terms, conditions and risks" of the transaction: *Futures and Options World* Issue 284, January 1995 at 12.

⁵⁴⁰ Compliance Rule 2-30.

The securities SROs require their members to "exercise due diligence"⁵⁴¹ or "make reasonable efforts"⁵⁴² to obtain information about investors before opening accounts or making investments on their behalf. The SRO member must believe that the recommended transaction is suitable on the basis of:

- information furnished by the customer concerning the customer's investment objectives, financial situation and needs and
- any other information known by the member.⁵⁴³

In addition, no member may recommend options without having a reasonable belief that the customer has sufficient knowledge to understand, and financial resources to bear, the risks of an options transaction.⁵⁴⁴

⁵⁴¹ New York Stock Exchange rule 721(b), American Stock Exchange rule 411.

⁵⁴² NASD Rules of Fair Practice Art III s 2(b). This does not apply where the customer is non-institutional or where the investment is limited to money market mutual funds. Despite this limitation on the information-gathering requirement, it is possible that the suitability requirement itself still applies to non-institutional customers and money market mutual fund investments.

⁵⁴³ NASD bylaws s 11 of Sch E, NASD Rules of Fair Practice Art III s 33, s 19(a) of Appendix E and American Stock Exchange rule 923(a) (the latter two require that the transaction be "not unsuitable"). Cf NASD Rules of Fair Practice Art III s 2(a) which only requires a recommendation concerning a purchase, sale or exchange of a security to be based upon any facts disclosed by the customer as to the customer's other security holdings, financial situation and needs. A 1994 Bill proposed by United States Congressman Gonzalez concerning the regulation of derivatives activities of financial institutions would authorise regulatory agencies to establish principles and standards for ensuring "that a financial institution does not recommend or engage in derivatives activities that the institution knows or has reason to believe would be inappropriate for a customer on the basis of available information": H.R. 4503, 103d Cong., 2d Sess., Title I, cl 101(c)(9).

⁵⁴⁴ For example, New York Stock Exchange rule 723 requires that the member have "a reasonable basis for believing ... that the customer has such knowledge and experience in financial matters that he may reasonably be expected to be capable of evaluating the risks of the recommended transaction, and is financially able to bear the risks of the recommended position in the option contract". A similar rule, but relating to the risks of proposed strategies or transactions, applies to trading of discretionary accounts for both the New York Stock Exchange (rule 724) and the American Stock Exchange (rule 924). See also NASD Rules of Fair Practice Art III s 33, s 19(b) of Appendix E. There are two types of suitability requirement in the suitability test to be satisfied before brokers approve accounts in low price OTC equity securities known as "penny stocks" (Securities Exchange Act reg 15g-9): reasonably determining "that transactions in penny stocks are suitable for the person" and "that the person ... reasonably may be expected to be capable of evaluating the risks".

Financial supervision

The CFTC imposes net capital requirements on futures commission merchants and introducing brokers and has also undertaken a risk assessment programme designed to identify exposures that affiliates of a futures commission merchant may have in other sectors, including OTC derivatives.⁵⁴⁵ The SEC has similar net capital requirements for brokers and dealers as well as a risk assessment programme.⁵⁴⁶

Advertising

Derivatives within CFTC jurisdiction

The anti-fraud provisions of the Commodity Exchange Act⁵⁴⁷ cover false advertising. They apply to derivatives within the CFTC's jurisdiction, including OTC derivatives within the swaps exemption.⁵⁴⁸ Also, commodity pool operators and commodity trading advisors are expressly prohibited from any advertising that would defraud a client or prospective client.⁵⁴⁹

National Futures Association members must have written supervisory procedures for reviewing all promotional material.⁵⁵⁰ The Association also has a voluntary pre-publication submission programme for screening advertising.⁵⁵¹

The CFTC does not currently specifically regulate cold calling but may promulgate rules "to prohibit deceptive and other abusive telemarketing acts or practices".⁵⁵² However, the Commodity Exchange Act requires registered futures associations to establish supervisory guidelines for telephone solicitation.⁵⁵³

⁵⁴⁵ Commodity Exchange Act reg 1.17.

⁵⁴⁶ Securities Exchange Act reg 15c3-1(a)(2).

⁵⁴⁷ Commodity Exchange Act ss 4b, 4o.

⁵⁴⁸ There is a specific exemption from the anti-fraud provisions for energy contracts: CCH Commodity Futures Law Reporter [1992-94] para 25,633.

⁵⁴⁹ reg 4.41.

⁵⁵⁰ Compliance Rule 2-29.

⁵⁵¹ Interpretive Notice 1 May 1989; NFA Manual 1 August 1994 para 9,009.

⁵⁵² Commodity Exchange Act s 6(f) (effective 16 August 1994).

⁵⁵³ Commodity Exchange Act s 17p(4). The guidelines may require that a member shall not enter an order for a new client solicited by telephone until 3 days after the opening of the account and receipt of a risk acknowledgement statement signed by

Derivatives within SEC jurisdiction

The SROs' rules establish detailed standards for the content and manner of presentation of options advertisements. Brokers and dealers must submit advertisements to SROs for approval or review before use. The SROs' rules provide that options advertisements must:

- . not be false or misleading
- . not promise specific results
- . not contain exaggerated or unwarranted claims, opinions or forecasts
- . not contain clauses disclaiming responsibility for its content
- . when discussing the uses or advantages of options, contain a warning that options are not suitable for all investors
- . balance statements that describe potential opportunities and advantages with appropriate reference to the corresponding risks.⁵⁵⁴

There are no specific cold calling rules. However, the risk disclosure and suitability requirements are directly relevant to cold calling.⁵⁵⁵

Transaction reporting

Futures commission merchants must give their clients:

- . monthly statements detailing transactions effected and funds held on their clients' behalf (if there is no activity in an account, the statement need only be prepared every three months)

the client. The National Futures Association has a telephone client solicitation programme to test sales methods, and can require those of its members who have been subject to disciplinary action to tape record all telephone sales conversations: Interpretive Notice 19 January 1993: NFA Manual 1 August 1994 para 9,021.

⁵⁵⁴ For instance, New York Stock Exchange rule 472 Supplementary Material .30, rule 791(a) and Supplementary Material .10, American Stock Exchange rule 481 Supplementary Material .30, rule 991(a) and Commentary .01.

⁵⁵⁵ These rules relate to low price OTC equity securities known as "penny stocks": Securities Exchange Act reg 15g-2 (risk disclosure requirement), reg 15g-9 (suitability requirement). The National Association of Securities Dealers Rules of Fair Practice relating to just and equitable principles of trade (Art III s 1) and suitable recommendations for customers (Art III s 2) are also relevant. High pressure telephone sales campaigns would breach the suitability rule: NASD Manual para 2,152.

- a written confirmation of a futures or option transaction or of the expiry or exercise of an option by the end of the next business day.⁵⁵⁶

Regular statements of account are to be given to participants by commodity pool operators.⁵⁵⁷ The statement must include complete information on the current state of all trading accounts in which the participant has an interest.

No transaction reporting requirements apply to OTC derivatives within the CFTC's swaps exemption.

Brokers and dealers must give their clients written confirmation of securities transactions.⁵⁵⁸ However, in certain cases, quarterly reports may be given instead.⁵⁵⁹

Protection of client money

Derivatives within CFTC jurisdiction

Futures commission merchants and clearing organisations must segregate and separately account for all clients' money, securities and property received to margin, guarantee or secure trades or contracts, or accruing to the client as a result of such trades or contracts.⁵⁶⁰ This segregation requirement also applies to banks and depositories where client funds are kept.⁵⁶¹ The funds in these accounts may be put into government-guaranteed investments⁵⁶² and the interest or any increment may be retained by the investing futures commission

⁵⁵⁶ Commodity Exchange Act reg 1.33.

⁵⁵⁷ Commodity Exchange Act reg 4.22.

⁵⁵⁸ Securities Exchange Act reg 10b-10(a).

⁵⁵⁹ This may be done where transactions are effected pursuant to a periodic plan (defined in Securities Exchange Act reg 10b-10(e)(5)) or an investment company plan (defined in reg 10b-10(e)(6)): reg 10b-10(b).

⁵⁶⁰ Commodity Exchange Act s 4d(2).

⁵⁶¹ The depository organisation with which funds are lodged must sign an acknowledgement that it was informed that the funds deposited are held in accordance with the Commodity Exchange Act and regulations: reg 1.20(a). This prohibits the depository from exercising set-off or lien rights against the funds.

⁵⁶² The permitted investments are United States federal or State government-guaranteed securities: Commodity Exchange Act s 4d(2), reg 1.25. Proceeds from any sale of these investments must be redeposited in the account.

merchant or clearing organisation.⁵⁶³ A futures commission merchant may

⁵⁶³ Commodity Exchange Act reg 1.29.

pool all segregated client funds into a single account which must be clearly identified as belonging to clients.⁵⁶⁴

A futures commission merchant may not use a segregated client's funds to cover the margin or other obligations of another person or to cover other obligations of that client, such as a deficit in the client's securities account or margins on foreign futures positions.⁵⁶⁵ However, clients may authorise transfers by futures commission merchants from their segregated commodity account to cover deficits in their other accounts carried by that futures commission merchant. The system of segregation differs in the clearing house, which may draw against a clearing member's customers' account to cover a default of the clearing member precipitated by a client (though not a default in consequence of the clearing member's trading on its own account), even if this means using other clients' funds.

A futures commission merchant may have a residual financial interest in client funds. For instance, the merchant may deposit its own money into the segregated account to provide a cushion and to avoid a charge being made against the merchant's capital for the undermargined amount.⁵⁶⁶

The CFTC enforces these rules by overseeing SRO financial surveillance programmes.

Derivatives within SEC jurisdiction

Brokers and dealers must, weekly or monthly, calculate the amount of funds they hold on behalf of clients. If that amount exceeds the total of funds which the broker-dealer is owed in relation to all client transactions, the broker-dealer must deposit the excess in a Special Reserve Bank Account.⁵⁶⁷ However, the broker-dealer may keep interest earned on this account.

The self-regulatory organisations have the primary regulatory responsibility for supervising the treatment of client funds. The SROs are supervised by the SEC through periodic on-site inspections to ensure that the SRO is providing adequate supervision.

⁵⁶⁴ Commodity Exchange Act reg 1.20(c).

⁵⁶⁵ Commodity Exchange Act reg 1.22.

⁵⁶⁶ Commodity Exchange Act reg 1.23.

⁵⁶⁷ Securities Exchange Act reg 15c3-3.

Compensation funds

Derivatives within CFTC jurisdiction

There is no fund to compensate customers who have been defrauded or otherwise mistreated by a registrant for either exchange traded futures or OTC derivatives.⁵⁶⁸ The CFTC has recommended against the creation of any such compensation scheme in view of the very low levels of loss through defalcation or other misconduct in trading of instruments subject to its jurisdiction.⁵⁶⁹

Derivatives within SEC jurisdiction

The Securities Investor Protection Corporation (SIPC) provides specific, limited protection to clients of securities firms which go into liquidation. It protects each client of an SIPC member for up to US\$100,000 per client for cash claims and US\$500,000 for cash and securities claims.⁵⁷⁰

In addition, SRO rules require their members doing business with the public to have fidelity bond coverage.⁵⁷¹

Gaming and wagering legislation

State anti-wagering and bucketshop laws do not apply to contracts traded on futures exchanges. Off-exchange trading allowed by a CFTC exemption order is also exempted from those laws.⁵⁷² The securities legislation specifically exempts options traded in accordance with the rules of a self-regulatory

⁵⁶⁸ Alternative means for compensating customers include the CFTC's reparations programme (Commodity Exchange Act s 14) and the availability of arbitration at the contract markets and the National Futures Association. Also, the net capital requirements for futures commission merchants and introducing brokers (Commodity Exchange Act reg 1.17) are intended to ensure that liabilities to customers for misconduct can be satisfied.

⁵⁶⁹ CCH Commodity Futures Law Reporter [1975-77 Transfer Binder] para 20,235 (1 November 1976).

⁵⁷⁰ Securities Investor Protection Corporation Act 1970 s 9.

⁵⁷¹ For instance, New York Stock Exchange Rule 319, American Stock Exchange Rule 330.

⁵⁷² Commodity Exchange Act s 12(e)(2).

organisation from State gaming, wagering and bucketshop laws.⁵⁷³ The State laws may, however, apply to OTC derivatives.

Netting

Overview

In the United States, netting contracts for financial transactions are enforceable notwithstanding insolvency if they fall within the protective provisions of one or more of:

- the Bankruptcy Code
- the Financial Institutions Reform, Recovery and Enforcement Act (1989) (FIRREA)
- the Federal Deposit Insurance Corporation Improvement Act (1991) (FDICIA).

FDICIA, the most recent legislation, has the broadest ambit. It permits netting of any type of financial agreement between "financial institutions". Its netting provisions deal with new products by regulating according to the character of the counterparties rather than the products.

The Bankruptcy Code and FIRREA apply only to specified types of financial agreements between specified participants. They do not permit netting of new types of financial agreement that fall outside their specified financial agreement categories.⁵⁷⁴

Bankruptcy Code

Exemption from automatic stay

The Bankruptcy Code applies to corporations and natural persons.⁵⁷⁵ When bankruptcy proceedings are begun under the Code, an automatic stay against legal proceedings and other enforcement action against the debtor and the

⁵⁷³ Securities Exchange Act s 28(a).

⁵⁷⁴ The Federal Deposit Insurance Corporation has a limited discretion to apply FIRREA to other products: see *infra* at 145.

⁵⁷⁵ Definition of "person" in s 101.

debtor's property comes into force.⁵⁷⁶ This automatic stay expressly applies to:

- any attempt to recover a claim against a debtor
- the set-off of any debt owing to the debtor against any claim against the debtor

that arose before the commencement of the bankruptcy proceedings.⁵⁷⁷

However, the automatic stay provisions do not apply to:

- set-offs of claims by commodity brokers, forward contract merchants, stockbrokers, financial institutions, or securities clearing agencies for margin or settlement payments in relation to commodity contracts, forward contracts, or securities contracts⁵⁷⁸
- set-offs of claims by repo participants for margin or settlement payments in relation to repurchase agreements⁵⁷⁹
- set-offs of claims by swap participants in relation to swap agreements⁵⁸⁰
- the use of collateral held to satisfy amounts due from the bankrupt party under a swap agreement.⁵⁸¹

⁵⁷⁶ s 362.

⁵⁷⁷ s 362(a)(6), (7).

⁵⁷⁸ s 362(b)(6). The expressions "commodity broker", "forward contract merchant", "financial institution", "securities clearing agency", "margin payment", "settlement payment" and "forward contract" are defined in s 101. The expressions "commodity contract" and "securities contract" are defined in s 761 and s 741 respectively.

⁵⁷⁹ s 362(b)(7). The expressions "repo participant" and "repurchase agreement" are defined in s 101. "Repurchase agreement" (repo) is defined as "an agreement, including related terms, which provides for the transfer of certificates of deposit, eligible bankers' acceptances, or securities that are direct obligations of, or that are fully guaranteed as to principal and interest by, the United States or any agency of the United States against the transfer of funds by the transferee of such certificates of deposit, eligible bankers' acceptances, or securities with a simultaneous agreement by such transferee to transfer to the transferor thereof certificates of deposit, eligible bankers' acceptances, or securities as described above, at a date certain not later than one year after such transfers or on demand, against the transfer of funds".

⁵⁸⁰ s 362(b)(14). The expressions "swap participant" and "swap agreement" are defined in s 101.

⁵⁸¹ s 362(b)(14).

Amounts retained by a creditor pursuant to these set-offs are also protected from recovery by a bankruptcy trustee.⁵⁸²

A possible major limitation of the Bankruptcy Code is that it may not protect set-off between different types of agreements, for instance, the set-off of a net amount owing under swap agreements against a net amount owing under forward contracts.⁵⁸³

Exemption from voidable transaction provisions

Certain transfers made before the commencement of proceedings under the Bankruptcy Code are protected from avoidance by a bankruptcy trustee, for example as being a voidable preference⁵⁸⁴ or a transfer at an undervalue.⁵⁸⁵ The protected transfers are:

- a margin or settlement payment by or to a commodity broker, forward contract merchant, stockbroker, financial institution, or securities clearing agency
- a margin or settlement payment by or to a repo participant in connection with a repurchase agreement
- a transfer under a swap agreement, by or to a swap participant, in connection with a swap agreement.⁵⁸⁶

Fraudulent transfers, that is those made with actual intent to hinder, delay, or defraud creditors, are not protected.⁵⁸⁷

In deciding whether a transfer is at an undervalue and therefore voidable:

- a commodity broker, forward contract merchant, stockbroker, financial institution, or securities clearing agency that receives a margin or settlement payment
- a repo participant that receives a margin or settlement payment in connection with a repurchase agreement

582 s 553.

583 Group of Thirty Report, Appendix II, Opinion of Cravath, Swaine & Moore at 304.

584 s 547.

585 s 548(a)(2).

586 s 546(e), (f), (g).

587 s 548(a)(1), s 546(e), (f), (g).

- a swap participant that receives a transfer payment in connection with a swap agreement

takes for value to the extent of the payment.⁵⁸⁸

In addition, variation and maintenance margins received from bankruptcy trustees with respect to open commodity contracts or forward contracts are protected from proceedings under the Bankruptcy Code.⁵⁸⁹

Enforcement of contractual liquidation terms

The Bankruptcy Code gives:

- stockbrokers, financial institutions, or securities clearing agencies in respect of securities contracts⁵⁹⁰
- commodity brokers or forward contract merchants in respect of commodity contracts⁵⁹¹
- repo participants in respect of repurchase agreements⁵⁹²
- swap participants in respect of swap agreements⁵⁹³

rights to enforce contractual liquidation or termination terms that are based on:

- the insolvency or financial condition of the debtor
- the commencement of a bankruptcy proceeding
- the appointment of or taking possession by a trustee in a bankruptcy proceeding or by a custodian before the commencement of a bankruptcy proceeding.⁵⁹⁴

588 s 548(d)(2).

589 s 556.

590 s 555. This is subject to a court or administrative order authorised under the Securities Investor Protection Act of 1970 or any statute administered by the Securities and Exchange Commission.

591 s 556.

592 s 559. This is subject to a court or administrative order authorised under the Securities Investor Protection Act of 1970 or any statute administered by the Securities and Exchange Commission where the debtor is a stockbroker or securities clearing agency. Also, where a repo participant has agreed to deliver assets under a liquidated repurchase agreement, the excess of the market prices for the assets when sold over the stated repurchase price plus liquidation costs is property of the bankrupt estate, subject to set-off rights.

593 s 560.

594 These three conditions are set out in s 365(e)(1).

The bankruptcy trustee may "reject" agreements that the parties specified above choose not to terminate or liquidate.⁵⁹⁵ The trustee can only reject an entire swap master agreement, not individual swap agreements under that master agreement.⁵⁹⁶ It has been suggested that the Bankruptcy Code should be amended to make it clear that:

- a master agreement under which swap agreements, forward contracts and securities contracts are documented should be treated as a single executory contract that the bankruptcy trustee must assume or repudiate as a whole
- parties to a master agreement may close out and promptly terminate a master agreement under which not only swap agreements but also securities contracts and/or forward contracts or any other similar agreements are documented.⁵⁹⁷

In addition, rights to offset or net out termination values or payments in relation to swap agreements are protected from proceedings under the Bankruptcy Code.⁵⁹⁸

FIRREA

This Act applies to "qualified financial contracts" where at least one of the parties is a "Federal depository institution" or "District bank"⁵⁹⁹ (depository institution). Qualified financial contracts⁶⁰⁰ are:

- securities contracts⁶⁰¹
- commodity contracts⁶⁰²

⁵⁹⁵ Using the bankruptcy trustee's power to reject executory contracts: s 365.

⁵⁹⁶ A master agreement together with its supplements is considered a single swap agreement: paragraph (C) of the definition of swap agreement in s 101.

⁵⁹⁷ Group of Thirty Report, Appendix II, Opinion of Cravath, Swaine & Moore at 304-305.

⁵⁹⁸ s 560.

⁵⁹⁹ Federal depository institutions are all national banks and other federal savings institutions: United States Code, Title 12, s 1813(c)(4). District banks are banks that operate under the Code of Law of the District of Columbia: United States Code, Title 12, s 1813(a)(4).

⁶⁰⁰ Defined in FIRREA s 212(e)(8)(D)(i).

⁶⁰¹ FIRREA uses the definition in s 741 of the Bankruptcy Code with modifications: s 212(e)(8)(D)(ii).

⁶⁰² FIRREA adopts the definition in s 761 of the Bankruptcy Code: s 212(e)(8)(D)(iii).

- forward contracts⁶⁰³

⁶⁰³ FIRREA adopts the definition in s 101 of the Bankruptcy Code: s 212(e)(8)(D)(iv).

- repurchase agreements⁶⁰⁴
- swap agreements.⁶⁰⁵

The Federal Deposit Insurance Corporation (FDIC) can determine that agreements similar to those specified are also qualified financial contracts.⁶⁰⁶

Termination and netting rights

When a conservator⁶⁰⁷ or receiver⁶⁰⁸ is appointed to a depository institution, the other party to a qualified financial contract will be entitled⁶⁰⁹ to:

- exercise any contractual right to terminate or liquidate the contract⁶¹⁰
- exercise rights under a security arrangement relating to the contract
- exercise any right to offset or net out any termination value, payment amount or other transfer obligation in relation to the contract.⁶¹¹

⁶⁰⁴ FIRREA uses the definition in s 101 of the Bankruptcy Code with modifications: s 212(e)(8)(D)(v).

⁶⁰⁵ Defined in s 212(e)(8)(D)(vi). The definition is virtually the same as that in s 101 of the Bankruptcy Code. The only differences are that the Bankruptcy Code refers to "an interest rate option" whereas FIRREA refers to an "interest rate option purchased" and FIRREA refers to an interest rate future and a currency future as well as options on interest rates and currency whereas the Bankruptcy Code only refers to the options.

⁶⁰⁶ s 212(e)(8)(D)(i).

⁶⁰⁷ The FDIC may act as a "conservator" of a federal depository institution: s 212(c)(2)(A)(i). A conservator has power to take such action as may be "necessary to put the insured depository institution in a sound and solvent condition" and as may be "appropriate to carry on the business of the institution and preserve and conserve the assets and property of the institution": s 212(d)(2)(D).

⁶⁰⁸ The FDIC may act as a receiver to realise the assets of a federal depository institution: s 212(c)(2)(A)(ii), s 212(d)(2)(E).

⁶⁰⁹ However, the party will not be entitled where a receiver transfers the contract pursuant to s 212(e)(9) to a depository institution that is not in default: see *infra* at 146-147.

⁶¹⁰ The right will arise on the appointment of a receiver: s 212(e)(8)(A). However, the right will not arise merely on the appointment of a conservator. It must be a separate contractual right: s 212(e)(8)(E). Thus, a contractual term permitting the contract to be terminated or liquidated if a conservator is appointed has no force.

⁶¹¹ s 212(e)(8)(A) (receiver), s 212(e)(8)(E) (conservator). The receivership provisions, but not the conservatorship provisions, deal explicitly with master agreements.

A receiver, but not a conservator, may apply for a temporary stay of any proceedings initiated by the other party to exercise these rights.⁶¹²

Avoidance of antecedent transactions

The FDIC, when acting as receiver or conservator, cannot avoid transfers of money or other property in connection with qualified financial contracts except where the transferee intended to hinder, delay, or defraud the depository institution, its creditors or a conservator or receiver appointed to it.⁶¹³ The FDIC may choose to enforce some agreements but repudiate others.⁶¹⁴ However, the FDIC cannot selectively enforce individual swap transactions under the one master agreement.⁶¹⁵

Transfer of contracts

A conservator or receiver can transfer assets or liabilities of a depository institution in default to another depository institution that is not in default.⁶¹⁶ The conservator or receiver need not transfer all the depository institution's

⁶¹² s 212(d)(12), s 212(e)(8)(B). The receiver can request a stay of 90 days.

⁶¹³ s 212(e)(8)(C).

⁶¹⁴ The power of a conservator or receiver to repudiate contracts that the conservator or receiver determines to be burdensome is in s 212(e)(1). The power of a conservator or receiver to enforce contracts notwithstanding a contractual provision for termination and other rights on insolvency or appointment of a conservator or receiver is in s 212(e)(12). Selective enforcement or "cherry-picking" is probably a greater risk in the appointment of a conservator (which a party cannot use to terminate a contract) than in the appointment of a receiver (where a party can terminate after one business day): DP Cunningham & WR Rogers Jr, "Netting is the Law" [1990] *Butterworths Journal of International Banking and Financial Law* (August) 354 at 356. There is some doubt whether the repudiation rules can be used to negate the anti-cherry-picking rules: *id* at 358 (note 5).

⁶¹⁵ s 212(e)(8)(D)(vii). There is a risk that a conservator or receiver might selectively repudiate contracts where some of the contracts under the master agreement cannot be categorised as swap agreements, but this could be dealt with by a provision such as that found in Section 5(a)(v) of the ISDA Master Agreement permitting the other party to a master agreement to terminate the master agreement and all transactions documented under it if there is an attempt to repudiate a transaction or group of transactions.: Group of Thirty Report, Appendix II, Opinion of Cravath, Swaine & Moore at 305.

⁶¹⁶ s 212(e)(9). The FDIC has stated that it will regard the right to transfer contracts as having expired if it has not been exercised by noon on the business day following the appointment of the FDIC as receiver: FDIC Policy Statement of 12 December 1989, cited in Cunningham & Rogers, *supra* note 614 at 354-355.

assets and liabilities. However, a conservator or receiver who decides to

transfer qualified financial contracts must transfer all the contracts entered into by a particular person or the person's affiliate with the defaulting depository institution, together with associated rights.⁶¹⁷ It is not permissible to transfer some only of a particular person's qualified financial contracts.

FDICIA

Counterparties covered by the netting provisions

FDICIA protects netting contracts of a "financial institution", defined⁶¹⁸ as:

- a broker or dealer⁶¹⁹
- a depository institution⁶²⁰
- a futures commission merchant⁶²¹
- any other institution as determined by the Board of Governors of the Federal Reserve System.⁶²²

⁶¹⁷ The associated rights are claims of or against the defaulting depository institution or affiliate and property securing those claims.

⁶¹⁸ s 402(9).

⁶¹⁹ Defined in s 402(1).

⁶²⁰ Defined in s 402(6). The definition covers national and state banks, credit unions, thrifts and United States branches and agencies of foreign banks. The legislation does not specify whether the operations subsidiaries of banks will be regarded as depository institutions. The Federal Reserve regards operations subsidiaries as incorporated departments of banks, and they engage in activities supervised and regulated on a consolidated basis with their parent banks: ET Patrikis & K Walraven, "The Netting Provisions of the Federal Deposit Insurance Corporation Improvement Act of 1991" May 1992 Vol XII No 3 *Futures International Law Letter* 1 at 3 (note 11 and accompanying text).

⁶²¹ Defined in s 402(10).

⁶²² Questions the Federal Reserve Board may have to consider in exercising its discretion to extend the netting provisions include:

- will it extend coverage of the Act's netting provisions to a foreign bank that is subject to comprehensive consolidated supervision and a capital adequacy regime comparable to that of the United States where that foreign bank is participating in a foreign exchange clearing house in the United States in which all other participants are financial institutions (only United States offices of a foreign bank are covered by the Act itself)
- should insurance companies, which are also regulated, be covered by the netting provisions
- should the netting provisions be extended to the swaps dealer-affiliates of a broker-dealer or of a bank (Patrikis & Walraven, *supra* note 620 at 3)?

All these institutions are regulated by United States government authorities and are subject to capital adequacy requirements.

Contracts covered by the netting provisions

A netting contract is defined⁶²³ as a contract or agreement between two or more financial institutions or members⁶²⁴ that:

- is governed by any United States law and
- provides for netting present or future payment obligations or payment entitlements⁶²⁵ (including liquidation or close-out values relating to the obligations or entitlements) among the parties to the agreement.

Where persons enter into contracts that are subject to the rules of a clearing organisation,⁶²⁶ those rules are deemed to constitute the netting contract for the purposes of FDICIA.⁶²⁷

Contracts that are invalid under or precluded by federal commodities law are not "netting contracts".⁶²⁸ This ensures, for instance, that the netting provisions do not inadvertently validate these contracts.⁶²⁹

The definition of netting contract will permit payment obligations representing different types of underlying obligations to be netted against one another, for example, foreign exchange trades against swaps.⁶³⁰ Also, it should validate a master-master agreement, that is, a netting contract that nets the amounts due under other netting contracts.⁶³¹

⁶²³ s 402(14)(A)(i).

⁶²⁴ Defined in s 402(11).

⁶²⁵ "Payment obligation" and "payment entitlement" are not defined.

⁶²⁶ Defined in s 402(2).

⁶²⁷ s 402(14)(A)(ii).

⁶²⁸ s 402(14)(B).

⁶²⁹ Patrikis & Walraven, *supra* note 620 at 4.

⁶³⁰ *Ibid.*

⁶³¹ This is another instance of where FDICIA gives greater netting protection than the Bankruptcy Code. Under s 362(b)(6) and (14) of the Code, a net amount owed by a debtor under a multiple, or master, forward contract could not be set off against the netting amount owed to the debtor under a master swap contract.

It is not clear that "cross-entity" netting contracts would be covered, for instance where financial institution A and financial institution B agree that the

obligations of company X, an affiliate of financial institution B that is not a financial institution, will be netted against the obligations of financial institution A.⁶³²

The netting provisions

The netting provisions provide that both bilateral⁶³³ and multilateral⁶³⁴ netting arrangements will be enforced pursuant to any applicable netting contract between financial institutions or clearing organisations.⁶³⁵

Bilateral netting. The general rule for bilateral netting is that "covered contractual payment obligations"⁶³⁶ and "covered contractual payment entitlements"⁶³⁷ between any two financial institutions are netted in accordance with any applicable netting contract.⁶³⁸ The respective obligations and rights to make or receive payment between two financial institutions bound by a netting contract are limited to the net obligation or net entitlement.⁶³⁹ Neither party, nor a receiver, conservator or the like, can make a claim based on the gross obligations between them, even if one of the parties is a failed financial institution.⁶⁴⁰

The net entitlement of any failed financial institution must be paid to it in accordance with the applicable netting contract.⁶⁴¹ The legislation does not specifically deal with what must be done if a failed financial institution has a net obligation, rather than a net entitlement. This contrasts with the position under multilateral netting.⁶⁴²

⁶³² Such an arrangement would raise regulatory issues relating to reporting, capital adequacy regimes, and transactions with affiliates. An argument can be made, however, that such cross-entity netting contracts would reduce systemic risk to an even greater extent, which would be beneficial to financial institutions: Patrikis & Walraven, *supra* note 620 at 7.

⁶³³ s 403.

⁶³⁴ s 404.

⁶³⁵ Enforceable netting contracts cannot be stayed: s 405.

⁶³⁶ Defined in s 402(5). The definition refers to a covered clearing obligation which is defined in s 402(3).

⁶³⁷ Defined in s 402(4).

⁶³⁸ s 403(a).

⁶³⁹ s 403(b), (c). Net obligation is defined in s 402(13). Net entitlement is defined in s 402(12).

⁶⁴⁰ s 403(e). Failed financial institution is defined in s 402(7).

⁶⁴¹ s 403(d).

⁶⁴² Patrikis & Walraven, *supra* note 620 at 5.

Examples of bilateral netting are:

- master agreements, such as those used for foreign exchange and swaps transactions
- novation agreements used in foreign exchange transactions.

Multilateral netting. The general netting principles applicable to bilateral netting also apply to multilateral netting. Covered contractual payment obligations and covered contractual payment entitlements of a member of a clearing organisation to and from all other members of a clearing organisation are to be netted in accordance with any applicable netting contract.⁶⁴³ The limitations on the obligations to make and rights to receive payment in multilateral netting⁶⁴⁴ are the same as for bilateral netting. Multilateral netting is effective notwithstanding that a person is a failed member of the clearing organisation.⁶⁴⁵ Again, a member of a clearing organisation has no obligation to pay, and no right to receive, any payment other than the net obligation or entitlement due from or to it.

A failed member is to be paid its net entitlement in accordance with the applicable netting contract.⁶⁴⁶ The net obligation, if any, of a failed member of a clearing organisation is determined in accordance with the applicable netting contract.⁶⁴⁷ Thus, even if a member of a clearing organisation has failed, the net obligation of that member is binding, even though it is not payable to a specific non-defaulting member. Further, a failed member of a clearing organisation has no recognisable claim against any member of a clearing organisation for any amount based on covered contractual payment entitlements other than its net entitlement.⁶⁴⁸

Types of multilateral netting include:

- having a clearing corporation as a central counterparty between the original two parties to a transaction (this type is used by securities, futures and options clearing corporations)

⁶⁴³ s 404(a).

⁶⁴⁴ s 404(b) and (c).

⁶⁴⁵ s 404(g). "Failed member" is defined in s 402(8).

⁶⁴⁶ s 404(d).

⁶⁴⁷ s 404(e). There is no equivalent in s 403.

⁶⁴⁸ s 404(f).

- having no central counterparty but netting amounts directly between participants. Each participant with a net debit position

owes a net amount, but that amount is not owed to a specific counterparty. It will be paid into a settlement account and aggregated with the payment of other net debtor settling participants. Funds in the settlement account are paid to net creditor participants.⁶⁴⁹

Prohibition on walkaway provisions

FDICIA appears to invalidate any provision under which the non-failing institution is not required to pay the failed institution its net entitlement.⁶⁵⁰

⁶⁴⁹ Patrikis & Walraven, supra note 620 at 5.

⁶⁵⁰ Patrikis & Walraven, supra note 620 at 7-8. The only obligation, if any, between the parties shall be the net obligation to make payment: s 403(b) and s 404(b). The net entitlement of the failed institution must be paid to it in accordance with the netting contract: s 403(d) and s 404(d).