Companies and Securities Advisory Committee

Regulation of On-exchange and OTC Derivatives Markets

Final Report

June 1997

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 in 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 Minister.

The members during the course of the Advisory Committee's derivatives review were:

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Philip Brown, Professor of Accounting - University of Western Australia, Perth
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David Crawford, Chairman - KPMG Peat Marwick, Melbourne
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History of the derivatives review

The Advisory Committee commenced its review of on-exchange and off-exchange (OTC) derivatives in mid-1994, following the release of the Australian Securities Commission (ASC) *Report on Over-the-Counter Derivatives Markets* in May 1994.

To assist the review, the Advisory Committee established an expert derivatives Panel drawn from the Sydney Futures Exchange (SFE), the Australian Stock Exchange (ASX), the ASC, the Reserve Bank of Australia (RBA), banks and merchant banks, representatives of professional associations, lawyers, accountants and academics. The Panel met on various occasions to discuss matters related to on-exchange and over-the-counter (OTC) derivatives. In preparing this Report, the Advisory Committee closely considered the range of views expressed by Panel members at those meetings. However, the recommendations in this Final Report are those of the Advisory Committee only.

As part of its review of derivatives, the Advisory Committee appointed a separate specialist Netting Sub-Committee to review and make recommendations on the law concerning netting of derivatives and other financial market transactions. This Sub-Committee consisted of experts from private practice, the exchanges and industry organisations. The Advisory Committee wishes to acknowledge and thank Bob Austin, Convenor of the Sub-Committee, and the other members of the Sub-Committee for the considerable time and effort that they devoted to preparing the Report on netting and the Netting Background Paper. The Final CASAC Netting Sub-Committee Report (*Netting in Financial Markets Transactions* (June 1997)) is separately published under the auspices of the Advisory Committee, in conjunction with this Final Report.

During the course of the review, the Advisory Committee published the following Papers:

- CASAC Research Paper *Law of Derivatives: An International Comparison* (January 1995) (CASAC Research Paper)
- Discussion Paper *Regulation of the OTC Derivatives Market* (August 1995) (OTC DP)
- Draft Report *Regulation of On-exchange Derivatives Markets* (June 1996) (On-exchange Draft Report)
- CASAC *Submission to the Financial System Inquiry* (January 1997).

In this Final Report, the Advisory Committee puts forward 50 Recommendations for the future operation of on-exchange and OTC derivatives markets. These recommendations are set out in Appendix 1 to this Report.

Appendix 2 to this Report contains a list of respondents to the OTC DP. Appendix 3 contains a list of respondents to the On-exchange Draft Report. Appendix 4 contains a list of members of the derivatives Panel.

This Report does not deal with the taxation aspects of derivatives.

This Report retains the nomenclature and functions of the existing regulators, namely the ASC, the RBA, the Insurance and Superannuation Commission (ISC), the Australian Financial Institutions Commission (AFIC) and the Council of Financial Supervisors. It does not deal with possible changes to the structure of regulators, or their respective functions, as proposed by the Australian Financial System Inquiry.[1]

Rationale of the derivatives review

Vast new markets in derivatives products, both domestic and global, have developed over the last decade. These markets are expected to continue growing in volume, diversity and complexity, given:

- the dismantling of national financial barriers and advances in communication technology, thereby facilitating international transactions and the movement of funds
- further advances in mathematical and computer modelling of financial market instruments
- the desire for participants to manage financial risk, protect against price changes or enhance revenue, by unbundling or re-designing traditional financial market instruments.

The Advisory Committee's review was prompted by the difficulties and uncertainties in applying current Australian law to these ongoing developments in derivatives markets. The Advisory Committee saw its task as developing appropriate, flexible and responsive prudential, disclosure and other methods of regulating the on-exchange and OTC Australian derivatives markets in a fair and orderly manner, while encouraging them to remain efficient, innovative and internationally competitive.

Outline of the Chapters and Recommendations

Chapter 1 *Nature of derivatives* explains the basic types of derivatives, the economic functions they perform in financial markets, how they are traded on-exchange and OTC, and the increasing globalisation of derivatives markets.

Chapter 2 *Methods and goals of regulating Australian derivatives markets* outlines the present regulatory structure for Australian on-exchange and OTC derivatives markets, and identifies a series of fundamental goals for regulating them in an efficient, effective and globally competitive manner. It contains recommendations for distinguishing between wholesale and retail market participants (Recommendation 1) and permitting retail participation in OTC derivatives markets (Recommendation 2).

1 The *Financial System Inquiry Final Report* (March 1997, AGPS) Recommendations 1 and 31 proposed that a Corporations and Financial Services Commission and an Australian Prudential Regulation Commission be established to regulate aspects of the Australian financial system. These agencies would carry out functions currently undertaken by existing regulators such as the Australian Securities Commission (ASC) and the Insurance and Superannuation Commission (ISC). The Reserve Bank of Australia (RBA) would retain a separate regulatory role.

Chapter 3 *Derivatives in the Australian financial system* analyses derivatives regulation in the broader context of Australian financial markets. It explains the functions and benefits of core financial markets regulatory criteria and the need, within these core criteria, to distinguish between derivatives and securities markets and products for certain purposes. It contains recommendations for defining derivatives and regulating them under the core financial markets provisions and supplementary derivatives-specific provisions (Recommendations 3-6).

Chapter 4 *Derivatives market regulation* deals with the proposed regulatory requirements for authorisation as a financial exchange to conduct a market in derivatives, or authorisation to conduct an OTC market in derivatives. The regulatory requirements are set out in Recommendations 7-12.

Chapter 5 *Licensing of derivatives market intermediaries* covers the proposed requirements for obtaining a financial markets licence endorsed for on-exchange derivatives broking or advising or OTC derivatives broking, market-making or advising. These requirements are set out in Recommendations 13-25.

Chapter 6 *Prudential regulation of on-exchange brokers and OTC market-makers* deals with proposals to assist these entities to manage their derivatives trading properly through risk management systems and capital standards. These requirements are set out in Recommendations 26 and 27.

Chapter 7 *Non-prudential regulation of derivatives market licensees* deals with various proposed statutory or exchange-based obligations for these licensees. These obligations are set out in Recommendations 28-43.

Chapter 8 *Other derivatives regulation* covers a range of regulatory issues applicable to on-exchange and OTC derivatives market participants, various proposed controls on derivatives market behaviour, and regulatory information-gathering and enforcement. The proposed regulatory initiatives are set out in Recommendations 44-50.

Corporate Law Economic Reform Program

In preparing this Report, the Advisory Committee has taken into account the Government's overall goal of developing corporate law policies within a wider economic framework, as described in the Government's *Corporate Law Economic Reform Program*, announced in March 1997. In particular, the Committee has closely considered and applied the six Principles for Reform, and the Action Plan for futures and securities markets, set out in that Program.

Principles for Reform

1. Cost/benefit analysis of new legislative proposals as against the existing law

It is necessary to make the regime for on-exchange and OTC derivatives trading more certain and less complex, given the growth in derivatives markets and the developments since the forerunner of the current legislation was enacted in the mid-1980s. Judicial decisions have also highlighted the extreme complexity of the current legislation that distinguishes between futures and securities, and the need for rationalisation.

The Advisory Committee proposes reforms to simplify the regulatory structure by eliminating current regulatory distinctions that have no sound policy justification, given the economic convergence of financial markets, but add considerably to compliance costs. For instance, the proposals to introduce core provisions for financial markets and financial market instruments would considerably reduce costs by overcoming regulatory duplication and uncertainty. Derivatives markets would also benefit from the proposals to specifically exempt all these markets from the gaming and wagering legislation.

The recommendation to introduce prudentially-based licensing requirements for OTC market-makers would reduce the possibility of financial failure by these key participants. These failures can add considerably to the cost to counterparties and to the markets generally.

The proposed use of internal risk management and capital standard models for some market intermediaries would encourage a supervisory approach that utilises market practices. The implementation costs would be outweighed by the benefits of these internal prudential controls for both these intermediaries and the markets generally.

The Report has a number of recommendations that distinguish between wholesale and retail participants. It proposes some regulatory safeguards exclusively for retail participants. The costs of these regulatory measures are outweighed by the assistance they provide to these persons in participating in derivatives markets. The Advisory Committee has sought to ensure that the protections for retail participants do not interfere with the operation of wholesale derivatives markets or impose additional compliance costs on those markets. The Advisory Committee also proposes to reduce the existing level of regulation of wholesale participants, for instance in relation to risk disclosure and benefits disclosure.

The Advisory Committee considers that the economic efficiency of derivatives markets depends on the timely and accurate flow of information to those markets and the avoidance of practices that interfere with their price discovery function. For instance, economic inefficiencies in a derivatives market may arise if trading occurs at artificial or distorted prices. The Advisory Committee proposes appropriate controls on derivatives markets to counter market manipulation and other improper marketing behaviour. The additional compliance costs are outweighed by the economic efficiency benefits to those markets.

2. *The development of a regulatory, legislative framework that is consistent, flexible, adaptable and cost-effective*

Regulation should be responsive to financial market changes. Regulatory failures occur where regulation falls behind market developments or impedes the adoption of new products, practices or technology. Flexibility and responsiveness to change are at the core of an effective regulatory framework. The Advisory Committee's review seeks to ensure regulatory flexibility through, for instance:

- *a core financial markets regulatory structure*
  This core structure would cover those areas of financial markets regulation that apply to all financial markets and their products, without the need to distinguish between derivatives and securities. This approach will enhance market symmetry and promote regulatory simplification and certainty.

- *a uniform procedure for approving financial exchanges*
  A single authorisation procedure for all financial exchanges will permit existing exchanges (which will automatically become financial exchanges) to develop innovative products without unnecessary regulatory impediments. It will also encourage the development of new financial exchanges which might wish to focus on particular financial products, possibly tailored for the needs of particular market participants.

- *a greater choice in conducting wholesale-only derivatives markets*
  The Advisory Committee proposes that applicants to conduct a wholesale-only market in any form of derivatives (whether fungible or customised) should have a choice between conducting an exchange market or an OTC market. This would allow greater flexibility in the conduct of wholesale-only derivatives markets.

- *a single financial markets licensing system*
  This will reduce application and processing costs while still recognising essential differences between various financial markets, through a system of endorsing licences.

- *a generic, rather than a product-based, definition of derivatives*
  A generic definition of derivatives would ensure that regulation in those areas where it is necessary to distinguish between derivatives and securities is based on the function of the instrument being regulated, rather than on

artificial product distinctions. This functional approach will assist product innovation by creating a clear and uniform regulatory regime for different types of derivatives.

Regulation should be cost-effective. The Advisory Committee's recommendations encourage this goal for derivatives markets and products in various ways, including:

- proposing that an activity need only be regulated as a derivatives market if so designated by the ASC. This would avoid the need for all affected parties to seek an exemption from being a derivatives market, as occurs under the current exempt futures market approach
- exempting persons who are authorised to conduct a derivatives market from being licensed for the same activities
- avoiding any duplication between existing regulators. For instance, market-makers who are prudentially regulated by the RBA or by some other appropriate regulator or self-regulatory organisation (SRO) would not also be subject to similar prudential regulation by the ASC.

Derivatives market regulation can also be made more cost-effective by drawing clearer distinctions between wholesale and retail derivatives markets and participants, as described below.

Wholesale. The Advisory Committee recommends permitting wholesale-only OTC derivatives markets in fungible derivatives, including futures contracts. These derivatives could be traded on these markets (provided that they operate in a fair and orderly manner) with a lower level of regulation than currently applies to exchange-traded futures contracts.

The Committee's proposed external regulation of wholesale OTC derivatives markets focuses on:

- licensing intermediaries, including OTC brokers and market-makers to wholesale end-users
- introducing cost-effective and risk-based prudential controls over OTC market-makers to wholesale end-users.

There would be some basic statutory safeguards for wholesale participants, namely:

- risk disclosure rights, subject to waiver by these participants
- measures to require OTC brokers to keep separate, and periodically account for, the funds and property of their wholesale clients, and
- suitability obligations where licensees make trading decisions for wholesale clients under managed discretionary accounts.

Retail. Some regulatory measures necessary to safeguard retail derivatives market participants would be inappropriate in the wholesale market and would impose unnecessary costs and regulatory burdens without any corresponding benefit. Various Advisory Committee recommendations apply for the benefit of retail participants only, for instance:

- creating a separate category of financial markets licence for those OTC market-makers who deal in derivatives with retail end-users, with competence and integrity as well as prudential requirements for these licensees
- requiring client agreements for retail clients
- providing retail end-users with an Advisory Services Guide, complaint resolution procedures for their dealings with brokers or advisers, mandatory derivatives risk disclosures and "know your client" protections
- ensuring that any deposit or margining funds or property provided by a retail OTC end-user to a counterparty are held in trust, notwithstanding any contrary terms in the OTC derivatives agreement.

These retail safeguards can be introduced without interfering with wholesale derivatives activity, or requiring a fundamental regulatory division between wholesale and retail derivatives markets.

A full outline of the proposed distinctions between wholesale and retail regulation in the OTC derivatives market is set out in the Table at the end of this Section on the *Corporate Law Economic Reform Program*.

3. Reduction of transaction costs for firms and market participants

Various Advisory Committee proposals are designed to reduce transaction costs, for instance:

- permitting disintermediated derivatives exchanges, thereby avoiding brokerage costs
- placing no statutory restrictions on the right of retail end-users to participate in OTC derivatives markets. Retail participants may reduce their overhead costs by tailoring derivatives transactions to their particular needs
- permitting wholesale-only OTC derivatives markets in fungible products, provided that these markets are operated in a fair and orderly manner. These markets may not require novation clearing and its consequential initial deposit and margin costs for participants.

4. The provision of an appropriate balance between government regulation and industry self-regulation

The Advisory Committee recognises the importance of co-regulatory arrangements between the ASC and industry organisations. It seeks to achieve an appropriate balance between government regulation and industry self-regulation in on-exchange and OTC derivatives markets, as follows.

On-exchange. The Advisory Committee considers that co-regulatory arrangements, with financial exchanges having the day-to-day responsibility for supervising conduct on their exchanges, and the ASC overseeing these regulatory activities, best ensure that exchange markets operate in an efficient, fair and orderly manner.

OTC. The Advisory Committee proposes that the ASC have responsibility for the overall supervision of OTC derivatives markets, primarily through its role in authorising OTC markets and licensing. The Advisory Committee also supports the initiatives by OTC industry-based groups in introducing self-regulatory codes of conduct, compliance guidelines and dispute resolution procedures, and otherwise encouraging appropriate standards in the OTC derivatives market. These private regulatory arrangements can promote a strong culture of compliance, and set standards of accepted market practice. Also, some of these industry-based requirements (for instance, dealer accreditation standards) can complement, or be recognised for the purpose of, statutory licensing. Where appropriate, the regulator could devolve responsibility for competency training and testing to industry bodies.

5. The removal of barriers to entry for service providers

The Advisory Committee supports the principle of competitive neutrality in derivatives markets to remove unjustified barriers to entry for service providers. Competitive neutrality requires that markets should be open to the widest range of service providers, with entry criteria being no greater than necessary to safeguard the market and its participants.

The Advisory Committee's recommendations encourage these competitive neutrality goals in various ways, such as:

- permitting any reputable corporate entity to apply to conduct either an on-exchange or OTC derivatives market by demonstrating that it can operate that market in an efficient, fair and orderly manner. Market providers will have greater flexibility in how they satisfy these principles-based criteria
- permitting an applicant who wishes to conduct a wholesale-only derivatives market to choose between an on-exchange or OTC market. This would allow greater flexibility in the conduct of wholesale-only derivatives markets
- permitting any person who can satisfy the necessary prudential requirements to act as a market-maker in the wholesale OTC derivatives market

6. The improved harmonisation of Australia's regulations and laws applying in major world financial markets.

The Australian financial system, including its derivatives markets, is becoming increasingly integrated into the global financial system. This ongoing change, promoted by technological advances and the dismantling of financial barriers between nations, is reflected in the growing level of cross-border OTC derivatives and other financial market activity.

Any reform of the Australian derivatives market must take into account comparable overseas laws and practices. The Advisory Committee has considered the nature and functions of derivatives regulation in other major jurisdictions, in particular the UK, the USA and Canada. It has also fully taken into account global developments and precedents, including relevant principles set down by the Basle Committee on Banking Supervision (the Basle Committee), by the International Organisation of Securities Commissions (IOSCO) and by other overseas government and self-regulatory organisations involved in derivatives regulation. The Advisory Committee also supports the continued use of ISDA and other Master Agreements in OTC derivatives transactions.

This focus on international harmonisation was particularly relevant to the Advisory Committee's consideration of:

- contract protection controls
- prudential regulation of OTC market-makers
- risk disclosure
- "know your client" requirements
- protecting clients' assets
- record-keeping
- discretionary accounts
- derivatives activity disclosure
- marking derivatives to market
- supervisory disclosure, and
- global regulatory and information-sharing arrangements.

Action Plan

1. Determining the appropriate policy response to the growing importance of derivatives in financial markets

The Advisory Committee sees the principal purpose of regulating Australian on-exchange and OTC derivatives markets as ensuring that they work efficiently and equitably, while remaining globally competitive. This overall goal can be met through specific prudential, disclosure and other regulatory mechanisms to achieve or maintain:

- market stability
- market symmetry and regulatory simplification
- appropriate intermediary-client arrangements
- retail participant protection
- trading integrity.

The Advisory Committee recognises that any regulatory system must be sufficiently flexible to respond to future changes in the financial market. Also, external regulation should be kept to the necessary minimum and complement, rather than weaken, private regulation of that market. Any unnecessary regulatory interference with normal market practices could destabilise, rather than support, the market and impede its growth.

The Advisory Committee sees OTC private regulation through market forces, self-help and industry initiatives, when combined with disclosure and other appropriate external regulatory controls and retail protections, as best promoting the objectives of maintaining general OTC market stability and market growth.

2. *Ensuring that regulation is facilitating the development of new financial products, encouraging competition between market providers and promoting the adoption of appropriate risk management procedures*

Facilitating new financial products. The current regulatory division between securities, futures contracts and other derivatives under Australian law is both a source of legal complexity and a potential impediment to encouraging innovative and competitive financial products.

The Advisory Committee supports functional regulation through core provisions that apply to all financial market instruments and supplementary derivatives-specific regulation that applies a generic rather than a product-based derivatives definition. This approach will permit product innovation on a more predictable regulatory basis by:

- overcoming current differential regulation for products with the same economic characteristics and risk management functions, depending on whether they are futures contracts, securities or neither

- resolving uncertainty about the categorisation of some new derivatives products under the existing definitions, and

- reducing the risk that the derivatives definition, and its regulatory consequences, will become obsolete or inappropriate as new products develop.

Encouraging competition between market providers. The Advisory Committee proposes a single authorisation procedure for financial exchanges, regardless of whether they conduct a market in securities, derivatives or both. This would encourage greater competition between authorised exchanges.

In addition, the Advisory Committee's proposals for the removal of barriers to entry for service providers (as discussed in Point 5 of the Principles for Reform, supra) are designed to encourage competition between these intermediaries in on-exchange and OTC derivatives markets.

Promoting appropriate risk management procedures. The Advisory Committee recommends that OTC derivatives market-makers be required to implement risk management systems as a condition of their licensing approval. The financial and operational soundness of these intermediaries is fundamental to the stability of any market in which they operate. The Advisory Committee proposes that licensees be required to devise appropriate risk management systems, rather than having them externally imposed. This strengthens the market orientation of regulation.

Risk management requirements have a preventative role, by reducing the likelihood of these entities defaulting. They are not intended to provide any form of regulatory assurance that all the financial commitments of each market-maker will be kept. Instead, they would reduce the overall likelihood, or adverse market impact, of failure by particular market-makers, and thereby limit any systemic risk danger to other parts of the financial system.

3. Examining the appropriate level of regulation of over-the-counter markets and financial instrument exchanges

Financial exchanges. The Advisory Committee proposals fully endorse the system of co-regulation of financial exchanges. The exchanges have the expertise to develop specific and detailed business rules for the proper conduct of their members and for trading particular classes of derivatives, while balancing commercial viability with the need to maintain public confidence in their markets. These business rules provide a flexible and effective framework for the day-to-day operation of the market.

OTC. The Advisory Committee proposes a series of focused legislative initiatives designed to promote and maintain the stability of OTC derivatives markets and encourage appropriate conduct within those markets. These initiatives include:

- an authorisation process for conducting an OTC derivatives market
- licensing OTC brokers, market-makers and advisers
- regulating the relationship between these intermediaries and their clients, the proposed safeguards being mainly for retail end-users
- regulating market behaviour, for instance controls over undesirable advertising or market manipulation.

In addition, netting legislation (as recommended by the Netting Sub-Committee in its Final Report[2]) would assist the private regulation of those markets.

The Advisory Committee supports national and international initiatives for greater periodic disclosure, and information-sharing, of on-exchange and OTC derivatives, and other financial market, activities. It puts forward various proposals to assist that information-sharing process.

4. Exploring the optimum arrangements for co-regulation between self-regulatory organisations and the ASC

The Advisory Committee has proposed co-regulatory arrangements between the ASC, exchanges and industry bodies. These are outlined under Point 4 of the Principles for Reform, supra.

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2 CASAC Netting Sub-Committee Final Report *Netting in Financial Markets Transactions* (June 1997).

OTC Derivatives Markets

Proposed statutory obligations of OTC licensees to their wholesale (W) and retail (R) clients

	Brokers	Market-makers to W end-users	Market-makers to R end-users	Advisers
Client agreements	R		R	R
Risk disclosure	W (unless waived) & R	W (unless waived)	R	W (unless waived) & R
Personal derivatives recommendations				R
Benefits disclosure				R
Contract notes	W & R			
Periodic statements	W & R			
Separating client funds and property	W & R			
Record-keeping of clients' transactions	W & R		R	
Managing discretionary accounts	R		R	
Suitability for discretionary accounts	W & R	W	R	
Cold calling	R		R	R

Indication of any buy-back undertaking			R	

Financial System Inquiry

The Report of the Inquiry into the Australian Financial System was presented to the Treasurer in March 1997. That Report contained a number of recommendations which were particularly relevant to the Advisory Committee's review of on-exchange and OTC derivatives markets. The Advisory Committee has given close attention to these recommendations in preparing its Final Report. In particular, the Advisory Committee has taken into account the Financial System Inquiry recommendations relating to:

- Commission powers (rec 2)
- financial exchange rules (rec 5)
- disclosure requirements for financial products (rec 8)
- single financial markets licence (rec 13)
- Commission power to delegate accreditation to industry bodies (rec 14)
- financial advice (rec 15)
- incidental financial advice (rec 17)
- prudential regulation of financial market licensees (rec 18)
- generic financial products regulation (rec 19)
- permitting retail participation in OTC derivatives markets (rec 20)
- authorising financial exchanges (rec 21)
- regulation of financial exchanges (rec 22)
- authorisation to conduct OTC markets (rec 23)
- authorisation of exchange clearing houses (rec 24)
- dispute resolution (rec 25)
- enforcement powers of the Commission (rec 27)
- Commission involvement in global regulatory programmes (rec 29)
- prudential regulation (rec 30)
- the prudential regulator (rec 31)
- Commission regulation of financial exchanges (rec 57)
- regulatory agencies to monitor wholesale markets (rec 58), and
- netting (rec 59).

These recommendations are analysed and discussed throughout this Final Report.

Chapter 1: Nature of derivatives

This Chapter explains the basic types of derivatives, the economic functions they perform in financial markets, how they are traded on-exchange and off-exchange (OTC), and the increasing globalisation of derivatives markets.

Elements of derivatives

1.1 Derivatives are financial market instruments whose values are derived from, or vary according to, the value of an asset or the level of a rate or index (the underlying). All derivative contracts are based on one or both of two primary elements:

- *the forward element*, under which there is an obligation to deliver or make a cash adjustment at some future time based on the current or future value of the underlying
- *the option element*, which gives the buyer of the option (the taker) the right, but not the obligation, to buy (call) or sell (put) the underlying at a certain stated price (the strike price) on or before[3] a specified future date (the expiry date).

1.2 Derivatives could be constructed over any underlying. In practice, the most common ones to date are over:

- a physical commodity (for instance, wool, cattle, oil or metals)
- a financial asset (for instance, shares, bonds or loan transactions)
- energy products (for instance, electricity)
- an index (for instance, a share price index)
- an interest rate
- a currency
- another derivative.

1.3 Derivatives may be physically settled (that is, by transfer of the physical underlying) or, more commonly, cash-settled (that is, by one party paying a cash amount to the counterparty).

Role of derivatives

1.4 Derivatives have several important functions in the financial market, including:

- *Risk management.* Derivatives may be a very cost-effective, efficient and expeditious way to transfer, hedge or adjust a financial risk or an exposure, or provide cash flow or price certainty. They may protect an asset against, or minimise a liability from, fluctuating market values or costs, for

3 There are two types of internationally recognised options. "American options" entitle the taker to exercise the option at any time before expiry. "European options" permit the taker to exercise the option only on the option expiry date.

instance, in commodities, equities, currencies, units of energy, interest rates or other financial variables. Derivatives can reduce uncertainty about future profitability. They may also protect credit providers against default risks or undue credit concentrations.

- *Diversification.* Derivatives can be used to diversify a financial portfolio.
- *Completing markets.* Derivatives can be constructed to unbundle or redesign existing financial market instruments and therefore offer market participants risk and return patterns that were previously unavailable, or too costly, to them on financial markets.
- *Achieving transactional efficiency.* Acquiring a derivative over an asset may be more cost-effective and quicker than buying that asset. For instance, a person with the funds to buy a share portfolio may instead purchase a share price index future, enter into an equity swap arrangement or acquire individual share futures. All these transactions represent some risk-taking on the future movement in share prices. However, a derivative which replicates a physical transaction may be entered into more quickly and with lower initial outlay, transaction costs and administrative charges.
- *Reducing volatility.* Derivatives markets for some products may be more liquid than the physical markets for those products and therefore be less vulnerable to the effect on pricing of individual trading.
- *Arbitrage.* Derivatives may be used to capture profits based on pricing anomalies, or product gaps, between different financial markets. This helps to enhance market efficiency.
- *Speculation.* Derivatives may be used by persons who have no direct interest in the subject matter of the derivative. Their involvement adds depth and liquidity to derivatives markets.

1.5 While derivatives promote economic efficiency in financial markets, they also have the capacity to create financial risks for participants in those markets. Some recent well-publicised failures by participants in the international derivatives market have highlighted the risks that can arise where derivatives activity is inadequately managed and controlled. Limited prudential, disclosure and other regulatory requirements may be necessary to maintain the efficiency of those markets. However, any regulation of derivatives must not hinder the operation and natural development of the derivatives markets.

Derivatives markets

On-exchange

1.6 Exchange-traded (on-exchange) derivatives are contracts whose fundamental economic terms (for instance, quantity, quality and maturity date) are standardised and not alterable by the contracting parties. These contracts are described as "fungible".[4] They are transacted on multilateral exchange markets which typically have a clearing house as the central counterparty for each transaction. The role of exchanges and clearing houses is to provide a mechanism for this trading, and the transfer of the economic risks involved, in a fair and orderly manner that ensures contract performance. The competitive and transparent exchange mechanism also promotes the public determination and dissemination of price information, by providing effective price signals concerning commodities, exchange rates or indices.

1.7 Currently, the Sydney Futures Exchange (SFE) and, to a lesser extent, the Australian Stock Exchange (ASX) conduct markets in derivatives in Australia.

1.8 The SFE conducts a market in futures contracts (being standardised forward contracts) and options over those contracts in relation to:

- commodities
- financial instruments
- financial indices
- shares and bonds.

1.9 The ASX conducts a market in the following derivatives:

- warrants[5]
- other share options (including low exercise price options (LEPOs)) and share index options[6]
- share ratio contracts.

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4 A fungible agreement is any standardised agreement that is fully interchangeable with a substitute transaction of the same class. The Group of 30 Report *Derivatives: Practices and Principles* (July 1993) at 32 stated that "full standardization leads to fungibility - that is, contracts of the same maturity are perfect substitutes. These characteristics are designed to facilitate anonymous trading in an active and liquid exchange market." The concept of fungibility was also recognised in *SCF Finance Co Ltd v Masri* [1986] 2 Lloyd's Law Reports 366 at 369, where Slade LJ stated that "interchangeability ... allows buyers and sellers to offset or liquidate any of their open positions with an equal and opposite transaction". The concept of fungibility is also reflected in para (a) of the definitions of "close out" and "liquidating trade" in s 9 of the Corporations Law. The fungibility element permits on-exchange futures contracts to be closed out by entering into opposite contracts and the clearing house matching the positions. This crystallises the profit or loss inherent in the original contracts. The same close-out method is used for all options (other than warrants) and share ratio contracts traded on the ASX: see ASX r 10.8 and definitions of "Open Contract", "Market Contract" (in relation to a Ratio Contract) and "Market Contract" (in relation to an Option) in Section 12 of the ASX Rules.

5 A warrant is a type of long-dated ASX-traded option. Currently, warrants are traded over specified shares, baskets of shares and the All Ordinaries Index. The warrant holder has the right, at settlement, to acquire the subject matter of the warrant, or an appropriate payment, from the issuer. The ASX must authorise on-exchange trading in that warrant. The issuer must remain a party to the warrant until settlement.

6 See s 92(1)(e) and the s 9 definition of "option contract".

OTC

1.10 Over-the-counter (OTC) derivatives are contracts whose fundamental economic terms are not standardised, and therefore require bilateral negotiation between the counterparties. The traditional role of the OTC market is to permit participants to design these customised products for their individual needs. These products may often involve commodities, instruments or maturity dates not offered on any exchange. They are also free of the margining requirements, or other contract protections, of exchange clearing houses.[7]

1.11 Derivatives transacted OTC range from simple forwards and option contracts to more complex synthetic instruments constructed from these fundamental products, such as swaps, reverse swaps and swaptions.[8]

1.12 In OTC markets, unlike on-exchange markets, participants trade directly with each other, typically by telephone or computer. Also unlike on-exchange markets, there is no centralised mechanism for the public determination and dissemination of OTC market prices. However, some limited OTC price quotation is available through information services.

1.13 Unlike on-exchange derivatives transactions, the contractual terms of OTC derivatives typically provide that these derivatives cannot be transferred or terminated without the consent of the counterparty.

Derivatives in international markets

1.14 The Australian financial system, including its derivatives markets, is becoming increasingly integrated into the global financial system.[9] That international system is currently being fundamentally transformed as:

- financial barriers between nations, such as foreign exchange and other controls, are being dismantled
- technological developments permit the creation of increasingly complex and diverse derivatives and other financial products
- advances in communication technology allow for immediate and relatively inexpensive cross-border trading, and

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7 The CSR *On-exchange Submission* pointed out that, for corporates, OTC rather than exchange-traded contracts may be better hedging instruments, given that:
  - managing and accounting for exchange margin calls involves extra administration
  - corporates have smaller exposures which they may wish to hedge, for instance, by matching specific dates to the underlying exposure. This flexibility may only be available on the OTC market.

8 For instance, swaps are private arrangements between two parties to exchange cash flows in the future according to an agreed formula. That formula could relate, for instance, to the values, at particular times, of stipulated assets, rates or indices. A summary of activity in the current Australian OTC swap market is found in the Australian Financial Markets Association (AFMA) 1996 *Australian Financial Markets Report*.

9 The *Financial System Inquiry Final Report* at 154 observed that "Australia's financial system will continue to remain highly integrated with global markets and, indeed, can be expected to become even more integrated as technology enables greater access to overseas markets".

- institutional structures are undergoing rapid change through the growth of diversified financial groups and the combining of previously separate financial activities such as banking, securities and futures trading and insurance.

1.15 These ongoing changes to financial markets are reflected, in Australia, in the growing level of cross-border OTC derivatives and other financial market activity. Participants in the Australian derivatives market may include branches or subsidiaries of overseas entities. Likewise, derivatives transactions involving Australian entities may take place in, or involve the laws of, overseas jurisdictions.

1.16 The globalisation of financial markets, while encouraging competition and innovation, can also pose novel problems. Effective regulation can no longer be achieved at the national level alone. For instance, global financial markets can accelerate the cross-border transmission of any financial disturbances originating in poorly regulated financial centres. A systemic risk problem can arise if this disturbance leads to the failure of a large multinational bank or other global derivatives market participant. In addition, global market competition can be distorted by divergent or inconsistent regulation between nations.

1.17 The Basle Committee and the International Organisation of Securities Commissions (IOSCO) were formed to improve the quality of financial markets supervision worldwide and to respond to global financial market developments in a timely and efficient manner. These organisations are working to develop and apply appropriate standards for derivatives and other financial markets trading, with the object of minimising systemic risks, preventing the erosion of agreed-upon prudential standards and otherwise ensuring the effective operation of these markets.

1.18 For instance, various market regulators, including the ASC,[10] reached an agreement (the Windsor Declaration), in May 1995, to improve existing mechanisms for international co-operation and exchange of information among market authorities and regulators and strengthen the arrangements for supervising the international futures market, including OTC derivatives. IOSCO and the Basle Committee formally supported this Declaration.

1.19 The Advisory Committee supports these initiatives to reach international agreements on regulatory issues that affect the global financial markets. The Advisory Committee does not see its role as attempting to resolve global market issues. Rather it puts forward recommendations for minimal appropriate regulation of the Australian on-exchange and OTC derivatives markets, and to assist these markets to be

10 The other regulators were the Comissão de Valores Mobiliários (Brazil), the Ontario Securities Commission (Commission des Valeurs Mobilières du Québec), Commission des Opérations de Bourse (France), Bundesaufsichtsamt für den Wertpapierhandel (Germany), Securities and Futures Commission (Hong Kong), Commissione Nazionale per le Società e la Borsa (Italy), Securities Bureau of the Ministry of Finance (Japan), Securities Board of the Netherlands, The Monetary Authority of Singapore, the Financial Services Board (South Africa), Comisión Nacional del Mercado de Valores (Spain), the Swedish Financial Supervisory Authority, The Federal Banking Commission (Switzerland), the US Commodity Futures Trading Commission, the US Securities and Exchange Commission, the UK Securities and Investments Board.

internationally innovative and competitive, while meeting internationally recognised regulatory standards. More stringent controls could unnecessarily place the Australian markets at a competitive disadvantage. Equally, under-regulation could lead to undesirable practices in these derivatives markets.

1.20 The Advisory Committee also endorses the role of internationally recognised International Swaps and Derivatives Association (ISDA) and other Master Agreements in the OTC market. These Master Agreements were originally developed in the USA and Europe in response to concerns about the enforceability of contractual netting arrangements, and to harmonise and expedite the documentation process in OTC markets. Master Agreements are continually evolving for existing and new derivatives products. The Advisory Committee recognises the progress made through these international efforts and fully supports the continued use of Master Agreements in the Australian OTC derivatives market.

Chapter 2. Methods and goals of regulating Australian derivatives markets

This Chapter outlines the present regulatory structure for Australian on-exchange and OTC derivatives markets, and identifies a series of fundamental goals for regulating them in an efficient, effective and globally competitive manner.

Current regulation of Australian derivatives markets

2.1 There are three overall approaches to regulation:

- *a statutory approach* - where specific and detailed laws are enacted by Parliament and thereafter administered by a regulatory agency
- *a co-regulatory approach* - where "framework legislation" sets out general principles for market conduct and consumer protection, with the regulator having an overall supervisory role and the specific regulation of transactions being left to industry groups supported by appropriate provisions, and
- *a self-regulatory approach* - where there is no specific legislative backing for schemes administered by industry groups. This is sometimes described as private regulation.[11]

A combination of these three approaches is currently used in the regulation of the Australian on-exchange and OTC derivatives markets.

On-exchange

2.2 Currently, all futures contracts must be exchange-traded[12] (or traded pursuant to exchange business rules[13]), unless they are exempt from the Corporations Law definition of futures contract[14] or are transacted on an exempt futures market.[15] There is no equivalent on-exchange rule for those derivatives that are securities.

2.3 The on-exchange derivatives market is subject to statutory controls over market conduct, supported by a co-regulatory structure involving:

- Ministerial approval for the conduct of exchanges, clearing houses and futures or securities organisations.[16] The Minister may also disapprove any changes to their business rules[17]

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11 Compare *Financial System Inquiry Final Report* at 258.

12 s 1258(a).

13 s 1258(c). Currently, exchange for physicals (EFPs) are traded off-exchange but pursuant to the SFE business rules: SFE General By-law G.7.

14 s 72(1)(d).

15 ss 1123, 1127, 1258(b).

16 In the context of futures, refer to ss 1126, 1131 and 1132. For securities, refer to ss 769, 770 and 779B.

17 In the context of futures, refer to s 1136. For securities, refer to ss 774, 779C.

- ASC supervisory and intervention powers over exchanges and market activities
- licensing controls over brokers and advisers, administered by the ASC, and
- conduct of business rules imposed and administered by the exchanges and clearing houses.

2.4 The ASC's functional responsibilities include advising the Minister, monitoring these exchanges and licensing exchange intermediaries. The Commission's enforcement and surveillance programme covers the supervisory activities of the exchanges, exchange-trading and exchange members.

2.5 The ASC's role is overall regulatory review, rather than day-to-day supervision or intervention. The ASC performs this role by conducting periodic audits of the effectiveness of exchange supervision.[18] In particular circumstances, the ASC can close a futures exchange or suspend dealings in a particular class of on-exchange futures contract.[19] The ASC's power over a securities exchange is limited to prohibiting trading in particular on-exchange securities.[20]

2.6 The exchanges (the SFE and the ASX) are given considerable powers and responsibility for regulating their markets and trading behaviour. They must:

- ensure that their markets operate in a fair and orderly manner[21]
- supervise and discipline their members' activity, including compliance with record-keeping requirements and broker-client obligations, and
- monitor exchange activity, to ensure compliance with the business rules and guard against improper conduct or other breaches of the Corporations Law.

2.7 In addition, exchanges and clearing houses must assist the ASC in the performance of its functions.[22] For instance, the exchanges have entered into Memoranda of Understanding to immediately refer serious breaches of the Corporations Law or the business rules to the Commission. The ASC also has access to the trading floors, or trading facilities, of all exchanges.[23]

2.8 The regulatory role of the exchanges is reinforced by the power of the court to order observance or enforcement of exchange business or listing rules.[24]

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18 *Futures Industry Association Financial Integrity Recommendations* (June 1995) Recommendation 15 stated that regulatory authorities should conduct routine reviews of the principal functions of exchanges and clearing houses within their jurisdiction. The ASC's view is that "it will contribute most effectively not by having a system of parallel supervision of market and member matters, but by conducting periodic intensive ‘audits’ of the effectiveness of SFE supervision in these areas": ASC *Submission to the Parliamentary Joint Committee on Corporations and Securities: Derivatives Review* (29 March 1995) para 21.

19 s 1138(1)(a), (b).

20 s 775.

21 s 1137.

22 ss 1139(1), 776, 779D.

23 ss 1139(4), (5), 776(3), (4).

24 ss 777, 1140.

2.9 The Advisory Committee considers that co-regulatory arrangements, with exchanges conducting primary surveillance and the ASC having a more general monitoring role, would best ensure that these derivatives markets function in an efficient, competitive and orderly manner. The exchanges should have the expertise to develop specific and detailed business rules for the proper conduct of their members and for trading particular classes of derivatives, while balancing commercial viability with the need to maintain public confidence in their markets. The exchange business rules can provide a flexible and effective framework for the day-to-day operation of the market. A similar approach was supported by the Financial System Inquiry.[25]

2.10 The Advisory Committee noted the issue raised in some submissions to the Financial System Inquiry concerning the dual regulatory approvals required under the Corporations Law Chapter 8 and the Trade Practices Act s 88 regarding the articles, business rules and clearing and settlement systems of the Exchanges.[26] The Financial System Inquiry recommended that the ACCC should continue to be responsible for authorising financial exchange rules and arrangements under this provision of the Trade Practices Act.[27] The Advisory Committee does not further consider that matter in this Report.

OTC

Corporations Law

2.11 The effect of the Corporations Law is to create four product-based categories of OTC derivatives:

- those within the Corporations Law definition of securities and traded OTC[28]
- those specifically exempt from the Corporations Law, including interest rate and foreign exchange derivatives where at least one party is an Australian bank or merchant bank[29]
- those requiring an exempt futures markets declaration,[30] and

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25 The *Financial System Inquiry Final Report* proposed (at 283) that, in relation to the regulatory requirements for exchange-trading: "The [Commission] should focus on post-vetting against clearly articulated market integrity objectives, rather than approving individual exchange products or acting as the front line regulator of exchange members".

26 *Financial System Inquiry Discussion Paper* para 5.39.

27 *Financial System Inquiry Final Report* Recommendation 5.

28 These include options on shares and bonds and some equity derivatives.

29 s 72(1)(d).

30 s 1127; ASC Policy Statement 70. Typically, these are products offered by banks or merchant banks which are or may be futures contracts but are not covered by the specific product exemptions in s 72(1)(d). ASC Policy Statement 70 identifies the criteria the Commission considers in recommending an exempt markets declaration under s 1127. The ASC will not recommend an exemption for products which have the same essential characteristic of tradeability as those entered into on futures exchanges: ASC Policy Statement 70 para 59. Policy Statement 70 (paras 66-69) also exempts treasury operations within a corporate group. This applies to related bodies corporate as defined in s 50.

- those which are outside the definitions of futures contract and securities and do not require an exempt markets declaration, for instance, OTC commodity options.[31]

2.12 This classification of OTC derivatives transactions can create legal complexity and uncertainty, with different regulatory regimes applying to products with similar functional characteristics. For instance, banks or merchant banks can offer products falling within s 72(1)(d) to retail end-users free of external regulation of those products. By contrast, only wholesale counterparties can enter into any OTC transaction which is the subject of an exempt futures markets declaration.[32]

Other laws

2.13 Other statutory and common law rules may apply to OTC derivatives market activities. In some instances, OTC market participants may be liable for misrepresentation, negligence or misleading or deceptive conduct in their dealings with clients or counterparties:

- in contract or tort[33]
- as fiduciaries (where applicable),[34] or
- under s 52 of the Trade Practices Act 1974 (Cth) (or its State equivalents).

2.14 In limited circumstances, intermediaries may also have a common law duty to advise their clients of particular features of derivatives transactions or material changes to these derivatives transactions that may affect the client's financial position or obligations.[35]

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31 The Full Federal Court decision in *SFE Ltd v ASX Ltd* (1995) 16 ACSR 148 means that it may be possible to structure arrangements to avoid regulation under the Corporations Law by ensuring that they fall outside the statutory definitions of "futures contract" and "securities". The Full Federal Court ruled that commodity options, if traded off-market, came within neither definition. Thus they are unregulated under the Corporations Law. The Full Federal Court decision also puts in doubt whether any OTC options are regulated under the Corporations Law: M Starr, "Options: is compliance with derivatives regulation optional?" [1995] *Butterworths Corporation Law Bulletin* No 7 [136]. The *CASAC Research Paper* recognised (at 23-26) the peculiar difficulties involved in classifying options as futures contracts or securities under the current law.

32 ASC Policy Statement 70 prohibits retail participation in exempt futures markets.

33 See M Hains, "Duties and Obligations of a Futures Broker to his Client" (1987) 3 *Australian Bar Review* 122; E Kerr & P Ali "Know Your Client: Counterparty Relationships", *Seminar on G-30 Recommendations One Year On*, 5 April 1995; G Hammond "Know Your Contracts: Reflections on the collapse of Baring Brothers", *Seminar on G-30 Recommendations One Year On*, 5 April 1995.

34 Any adviser who gives advice in the course of a fiduciary relationship has a 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. See further *CASAC Research Paper* at 48-49.

35 *Oabate Pty Ltd v Nichols Commodities Pty Ltd* (November 1983, Supreme Court of NSW). The nature and extent of this duty should be determined by the circumstances of each case. Relevant factors would include:

- the volatility of the market for the commodity in question
- the client's trading experience

Regulation of banks and foreign exchange dealers

2.15 Banks are key participants in the OTC derivatives market. The role of the Reserve Bank of Australia (RBA) under the Banking Act is to maintain the financial stability of banks and protect depositors. To achieve this, it imposes prudential and other controls on banks, including:

- capital adequacy requirements
- liquidity requirements
- liquidity management systems requirements
- restrictions on banks' associations with non-banks
- limitations on credit exposure.

2.16 The RBA also requires banks to have risk management systems for their overall activities, including their derivatives trading. In addition, it has a programme of visits to banks to determine how they identify, measure and manage market risk and counterparty credit risk, including where those risks arise from transactions in OTC or on-exchange derivatives.

2.17 The RBA supervises foreign exchange trading. OTC foreign exchange derivatives cannot be traded in the Australian market unless one party to the transaction is an authorised foreign exchange dealer. The RBA requires these dealers to maintain minimum capital levels and to have adequate systems to monitor and control risks, including agreed limits on foreign currency exposures.[36]

Regulation of non-bank financial institutions

2.18 The Australian Financial Institutions Commission (AFIC) has responsibility for setting standards for State supervisors of non-bank financial institutions (NBFIs), including building societies and credit unions. This financial institutions legislative scheme imposes restrictions on:

- the purposes for which derivatives may be entered into (hedging only)
- the types of derivative contracts to which NBFIs may be parties
- the types of counterparties to these derivative contracts (generally only banks).[37]

- the availability of information concerning price movements to a client otherwise than through the broker
- the client's exposure to price movements
- any special instructions or practices, whether express or implied
- the availability of the client (M Hains, *Australian Corporation Law: Principles and Practice* (Butterworths) vol 3, para [8.1.0345]).

See also E Kerr & P Ali "Know Your Client: Counterparty Relationships", *Seminar on G-30 Recommendations One Year On*, 5 April 1995; G Hammond "Know Your Contracts: Reflections on the collapse of Baring Brothers", *Seminar on G-30 Recommendations One Year* On, 5 April 1995, J Lang & L Zietman, "Derivatives and the Need for End User Sophistication", *The Futures & Derivatives Law Review* (1996) Vol III, Issue 2, 1 at 2-4.

36 Banking (Foreign Exchange) Regulations.

37 Financial Institutions Code 1992 s 120.

2.19 Building societies and credit unions are also subject to capital adequacy requirements. Similar prudential requirements are foreshadowed for friendly societies.[38]

Regulation of insurance and superannuation entities

2.20 The Insurance and Superannuation Commission (ISC) regulates some end-users in the OTC and on-exchange derivative markets, namely superannuation funds, life insurance organisations and general insurance organisations. The ISC requires that these entities implement proper risk management policies and procedures if they propose to transact in derivatives. These entities must also disclose their derivatives trading to the ISC.

The Council of Financial Supervisors

2.21 The Council of Financial Supervisors, comprising the RBA, the ISC, the ASC and AFIC, was established to provide high level policy co-ordination on matters affecting the financial system, including derivatives. The Council is not a regulator in its own right, nor does it seek to override the statutory responsibilities of its members.

Private regulation of OTC markets

2.22 There is no equivalent in the OTC derivatives market of the co-regulatory structure that applies to exchanges. Instead, apart from ASC controls over exempt futures markets, and RBA prudential regulation of some OTC market operators, this market relies heavily on its own trading conventions and accepted documentation, promoted by industry-based bodies.[39] This reinforces the role of market forces (to engender behaviour acceptable to the market and eliminate financially unsound participants), self-help techniques (including the use of internal risk management systems, counterparty credit assessment and credit provision arrangements[40]) and netting arrangements as forms of private regulation of that market.

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38 It is expected that prudential regulation of friendly societies will come under this legislative scheme from 1 July 1997.

39 See, for instance, *AFMA Manual: Standards and Guidelines for Australian OTC Financial Markets* (*AFMA Manual*) Sections 4 & 5.

40 The Basle Committee Report *Risk Management Guidelines for Derivatives* (July 1994) has suggested some non-legislative means of reducing counterparty credit risk in the OTC market, including:

- credit enhancement techniques, such as collateral requirements or third party guarantees
- credit limits that consider both settlement and pre-settlement exposures for all counterparties
- credit line approvals from the counterparty before commencing business with that counterparty
- credit limits for counterparties, determined by persons who are independent of the derivatives function.

Other measures could include frequent marking-to-market of transactions with possible adverse effects being tested through internal stress assessment procedures.

2.23 The Advisory Committee acknowledges that Australian industry-based bodies, including the Australian Financial Markets Association (AFMA), play an important role in setting and maintaining a high level of ethical and operational standards in the Australian OTC market. The Advisory Committee supports the use of codes of conduct, compliance guidelines and dispute resolution procedures within the OTC industry.[41] These private regulatory arrangements can encourage a strong culture of compliance, and set standards of accepted market practice. Also, some of these industry-based requirements (for instance, the dealer accreditation standards[42]) can complement, or be recognised for the purpose of, statutory licensing. Where appropriate, the regulator could devolve responsibility for competence training and testing to industry bodies.[43]

2.24 However, there are no formal arrangements for monitoring day-to-day activity in the OTC market equivalent to those for the on-exchange market.

Goals of regulating Australian derivatives markets

Overview

2.25 The Financial System Inquiry indicated that one of its key concerns was to ensure that financial markets work efficiently and competitively.[44] The Advisory Committee adopts a similar approach. It sees the principal purpose of regulating Australian on-exchange and OTC derivatives markets as ensuring that they work efficiently and equitably, while remaining globally competitive. This overall goal can be met through specific prudential, disclosure and other regulatory mechanisms to achieve or maintain:

- market stability
- market symmetry and regulatory simplification
- appropriate intermediary-client arrangements
- retail participant protection
- trading integrity.

2.26 The Advisory Committee recognises that any regulatory system must be sufficiently flexible to accommodate and respond to future changes in the financial system. Also, regulation should be kept to the necessary minimum. Any unnecessary regulatory interference with normal market practices could destabilise, rather than support, the market and impede its growth. For instance, undue and inappropriate external regulation of the OTC derivatives market may weaken private regulation of that market by creating the problem of "moral hazard", that is, transferring some of the monitoring and evaluation responsibility from private market participants to external

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41 The *AFMA Manual* sets out detailed standards and guidelines, including market conventions and codes of conduct, for Australian OTC market participants. See, for instance, Section 3 Code of Conduct; Section 6 Chapter 3 Alternative Dispute Resolution; Section 8 Compliance.

42 *AFMA Manual* Section 7.

43 cf *Financial System Inquiry Final Report* Recommendation 14 (the Commission should have power to delegate accreditation responsibilities to industry bodies).

44 *Financial System Inquiry Final Report* at 177.

regulators, with reduced incentive for OTC market participants to properly protect themselves. Any external regulation of the OTC derivatives market must complement, rather than weaken, private regulation of that market. In addition, the costs of regulation should be proportional to the benefits. The Advisory Committee's proposed regulatory system has been developed with these factors in mind.

Market stability

2.27 Derivatives markets are designed to deal with various financial risks. However, they also have the capacity to create their own risks. Some parties may suffer considerable financial loss from their participation in those markets. Large profits and, equally, large losses, can be made on small initial outlays. Some leveraged derivatives significantly magnify the change in the value of the derivative compared to any change in its underlying asset or index and therefore the potential for either profit or loss. Also, the value of derivatives, and therefore the obligations arising from them, can change substantially within a short period.

2.28 The Advisory Committee considers that the regulatory goal of promoting market stability is not to remove the inevitable financial risks of derivatives trading, but to concentrate on core risk elements which could lead to contagion or systemic risk problems. Contagion or systemic risk is the risk that an undue number of failures, or the failures of key participants, in the derivatives markets could undermine the stability of those markets or related physical markets, thus creating greater economic problems. In the on-exchange and OTC derivatives markets, the core risk elements are:

- market risk
- counterparty credit risk
- large exposure risk
- market liquidity risk
- operational risk
- legal risk.

2.29 The Advisory Committee recognises that these risks are not confined to the derivatives market.[45] Also, they should be dealt with to the greatest degree possible by internal market mechanisms and private regulation. However, where necessary, these controls should be supported by various regulatory structures, in particular:

- appropriate clearing or other contract protection arrangements for all on-exchange derivatives markets
- licence-based prudential controls (risk management and capital adequacy) over market-makers in the OTC derivatives market
- risk disclosure, "know your client" and other protections for retail end-users, and
- legislation to uphold private netting arrangements.

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45 Securities Institute of Australia (SIA) *OTC Submission*.

2.30 Prudential controls over OTC market-makers have a preventative role, by reducing the likelihood of these entities failing to meet their derivatives financial commitments. This reduces the overall likelihood or market impact of failure, and thereby limits any danger to other parts of the financial system. However, prudential standards are not intended to be a guarantee of the continuing solvency of each market-maker, or provide any form of regulatory assurance that every derivative financial commitment will be kept. An optimal prudential regulatory system can still involve some individual financial failures, with counterparties bearing those costs. The Advisory Committee sees OTC private regulation through market forces, self-help and industry initiatives, when combined with disclosure and other appropriate external regulatory controls and retail protections, as best promoting the objectives of maintaining general OTC market stability and market growth.

Market risk (position risk)

2.31 This is the risk of adverse movements in the value of derivatives contracts in consequence of changes in the market price or value of the underlying commodity, rate or index. Some commentators refer to this as position risk.[46]

2.32 For exchange-traded derivatives, the participants (but not the clearing house) are exposed to market risk. Under the novation process, the original contract is replaced by two new contracts under which the clearing house is the counterparty to each of the original counterparties (who, under exchange requirements, are the dealers, not their clients[47]). Any adverse movement in the value of one side of the contract is offset by a corresponding increase in the value of the opposite side, thereby neutralising market risk for the clearing house. The consequences of market risk for participants are dealt with by clearing house margining requirements and close-out powers for defaults. Close-out is the process of effectively extinguishing obligations under existing contracts by entering into opposite contracts.

2.33 There is generally no equivalent of margining or close-out in the OTC market.[48] However, OTC market participants can reduce their market risk by entering into hedging or offsetting transactions in the more liquid on-exchange market. In addition, the impact of market risk can be reduced in the OTC market through the proposed prudential controls over market-makers, including their risk management obligations (such as "stress testing" to predict the effect of highly unusual market changes on positions held) and minimum capital requirements.[49]

Counterparty credit risk

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46 See ASX Public Consultation Document *Capital Adequacy for Securities Dealers* (November 1996) Chapter 6.

47 The novation process means that the clearing house becomes the buyer to the seller of an on-exchange contract and, conversely, the seller to the buyer of that contract.

48 Currently, there are clearing and settlement arrangements, such as the Reserve Bank Information and Transfer System (RITS), the Bank Interchange and Transfer System (BITS) and Austraclear. These clearing arrangements do not employ contract novation and mandatory margining systems.

49 Recommendations 26 and 27.

2.34 This is the risk that a counterparty will default, in whole or part, on its financial obligations under its derivatives contract. The loss due to the default of a counterparty is the cost of replacing the unperformed part of the original contract at the current market price. Counterparty credit risk is much greater in derivatives than in securities trading, given the often considerably longer contractual period for derivatives transactions prior to final settlement. Also, as contracting parties can adjust or even transform their risk exposures easily and quickly through derivatives, it may not be possible for parties to assess accurately the ongoing financial position of their counterparties.

2.35 For exchange-traded derivatives, the clearing house (but not the participants) is exposed to counterparty credit risk. Under the novation process, the clearing house becomes the counterparty for each registered contract. Counterparties are no longer in a contractual relationship with each other. For the clearing house, counterparty credit risk is dealt with through contract protection mechanisms such as clearing house margining requirements and close-out powers for defaults. The margining rules require participants to cover any increased costs or obligations of their derivatives transactions as they arise.

2.36 There is no equivalent of this continuous risk-monitoring and response mechanism in the OTC derivatives market. Instead, counterparty credit risk can be reduced by the use of master agreements which permit netting of obligations, and also by ensuring that these netting arrangements are enforceable.[50] Parties may also reduce the impact of counterparty credit risk through their own credit provision arrangements.[51] In addition, the proposed prudential controls for OTC market-makers are designed to reduce (but not eliminate) the possibility of these participants being unable to honour their contractual commitments.

Large exposure risk

2.37 This is an extension of counterparty credit risk, where a person has a large proportional exposure to a single counterparty.

2.38 In the on-exchange market, this risk is reduced through contract protection mechanisms, such as exchange and clearing house business rules dealing with open position limits,[52] and by linking the minimum capital requirements for dealers to these exposures.[53] In the OTC market, a similar adjustment approach could be applied to the proposed minimum capital requirements for market-makers.[54]

Market liquidity risk

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50 CASAC Netting Sub-Committee Final Report *Netting in Financial Markets Transactions* (June 1997).

51 Refer footnote 40, supra. Other measures could include frequent marking-to-market of transactions with possible adverse effects being tested through internal stress assessment procedures.

52 paras 4.94-4.96, post.

53 para 4.97, post. See also the proposals in the ASX Public Consultation Document *Capital Adequacy for Securities Dealers* (November 1996) Chapter 8.

54 paras 6.30-6.33, post.

2.39 This is the risk that a derivatives market may lack sufficient depth to facilitate efficient and inexpensive entry into and exit from that market. Participants may be unable, within a reasonable time, to unwind or offset a particular derivatives transaction at all, or near to its entry price, because of inadequate depth of trading. The terms of an OTC derivatives transaction may also prohibit that transaction from being assigned, transferred or terminated without the consent of the counterparty.

2.40 Market liquidity risk is more likely to arise with highly customised OTC derivatives transactions, although it could also occur for thinly traded on-exchange derivatives. Market liquidity risk could be drawn to the attention of new on-exchange or OTC derivatives participants through mandatory risk disclosure requirements.[55]

2.41 A market that is supported by a combination of market forces and focused external regulation will encourage greater participation and thereby add to market depth. This in turn will reduce market liquidity risk.

Operational risk

2.42 This is the risk that market participants may suffer substantial unexpected losses through the lack of appropriate or effective internal controls.

2.43 This risk may be reduced by appropriate risk management systems. In the on-exchange market, risk management requirements may be imposed on brokers by exchange business rules.[56] In the OTC market, risk management requirements would form part of the proposed prudential regulation of market-makers.[57] These controls would be in addition to existing common law and statutory provisions regulating the conduct of corporate controllers.[58]

Legal risk

2.44 This is the risk that a counterparty's performance obligations are legally unenforceable, through:

- a counterparty lacking the power to enter into derivatives transactions (ultra vires)
- transactions breaching regulatory prohibitions (such as gaming and wagering legislation)
- the legal documentation being inadequate or unenforceable (particularly for cross-border transactions), or
- the netting provisions being ineffective under bankruptcy or insolvency laws.

55 For on-exchange derivatives, refer para 7.18; for OTC derivatives, refer para 7.34, post.

56 Detailed proposals are set out in the ASX Public Consultation Document *Capital Adequacy for Securities Dealers* (November 1996) at 6.283-6.329.

57 Recommendation 26.

58 The directors of corporate end-users may be obliged to implement and supervise internal risk management systems, as part of their duties as directors: *Daniels v AWA Ltd* (1995) 16 ACSR 607.

2.45 In the on-exchange market, novation clearing houses bear all legal risks (other than ultra vires risk, which is borne by the contracting brokers) for all registered transactions. In the OTC market, legal risk can be reduced through use of Master Agreements, effective netting rules,[59] methods to deal with the ultra vires problem,[60] and appropriate exemptions from the gaming and wagering legislation.[61]

Market symmetry and regulatory simplification

2.46 The current Australian regulatory regime is fractured, with derivatives differently treated under the Corporations Law, depending upon whether they fall within the securities or futures contracts definitions, or neither.[62] This has been described as creating an arbitrary regulatory divide.[63] For instance, financial and commodity futures contracts are regulated exclusively under Chapter 8 of the Corporations Law (futures contracts), while Chapter 7 options and warrants are regulated under Chapter 7 of the Corporations Law (securities). Some derivatives, such as deliverable share futures and share ratio contracts, are regulated by a mixture of Chapters 7 and 8 provisions, through a deeming process.[64] This deeming technique was seen as an interim measure only, pending this Advisory Committee review.

2.47 The current split between Chapters 7 and 8 regulation of derivatives has some wider ramifications. For instance, the legal uncertainty about whether some classes of derivatives are futures contracts means that institutions marketing them could inadvertently be liable for conducting unauthorised futures markets. Also, retail end-users may be unable to transact in derivatives offered on exempt futures markets, regardless of their possible benefits.[65] Conversely, some derivatives products are unregulated[66] or may be structured primarily to avoid regulation.[67] Also, functionally similar option contracts may be differently regulated, depending on the market on which they are traded.[68] Moreover, there is a different licensing regime for

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59 See CASAC Netting Sub-Committee Final Report *Netting in Financial Markets Transactions* (June 1997).

60 para 8.95 ff, post.

61 paras 8.114-8.117, post.

62 *CASAC Research Paper* at 7-19.

63 Merrill Lynch *On-exchange Submission*.

64 ss 72A, 92A. Share ratio contracts have been deemed to be securities, notwithstanding that they are "adjustment agreements" under the futures contract definition. Similarly, deliverable share futures, deliverable bond futures, and options over them have been deemed to be futures contracts.

65 ASC Policy Statement 70 requires that facility providers and facility users in these markets satisfy a test of sophistication, as summarised in paras 48, 56.

66 There are some OTC derivatives such as OTC commodity options and compulsorily cash-settled options that fall outside the ASC's jurisdiction under the Corporations Law. These derivatives may also be unregulated by the RBA, the ISC and AFIC if entered into by parties who are not institutions regulated by those agencies.

67 For instance, swaps where payments are made on a gross, rather than a net, basis are not futures contracts: J O'Sullivan, *Derivatives Explained - An Introduction*, Paper given at the January 1996 ASC Summer School. The CASAC OTC DP at para 0.41 refers to other derivatives products that are unregulated, including compulsorily cash-settled options.

68 *CASAC Research Paper* at 23-26.

market-makers dealing with functionally and economically similar derivatives products, depending on whether they fall within the securities or futures definitions. Also, it is unclear whether a securities or futures exchange can trade derivatives products that are neither securities nor futures contracts.[69] The Financial System Inquiry raised similar concerns about this regulatory complexity.[70]

2.48 The Advisory Committee considers that instruments in on-exchange and OTC financial markets should be regulated to the greatest extent possible in a uniform manner. Within those markets, there should be similar regulatory treatment for derivatives products with similar functional characteristics. For this reason, it proposes a generic, rather than a product-based, definition of derivatives.[71] Functional regulation will also simplify regulation by eliminating distinctions that have no sound policy justification, remove regulatory impediments to the development of new derivative products (for instance, the uncertainty about when exempt markets declarations are required[72]) and assist product innovations by creating a clear and uniform regime for different types of derivatives.

2.49 Submissions to both the Advisory Committee derivatives review and the Financial System Inquiry[73] generally recognised the benefits of this broader derivatives-based approach, which would extend futures regulation to cover derivatives contracts more generally.

Appropriate intermediary-client arrangements

2.50 The rules for the handling by brokers of their clients' orders, the protection of clients' assets and the completion of their clients' transactions should be identical for

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69 The argument that the exchanges can trade these products is that the Corporations Law only prohibits unauthorised markets in securities and futures. It does not regulate products which are neither futures contracts nor securities. The contrary view is that exchanges can only lawfully trade products for which they have a specific authorisation under the Corporations Law. Even if they can trade these other products, other protections may not apply, for instance the statutory fidelity fund arrangements. Given this, regulations were enacted to permit the SFE to trade deliverable share futures and deliverable bond futures, notwithstanding that, at least in relation to deliverable bond futures, it is arguable that they were not regulated by the Corporations Law as they were neither securities nor futures. For an argument that deliverable bond futures are not futures contracts, see F Donnan, "The Share Ratio Act: Innovation or Experimentation in Securities Regulation?" (1996) 14 *Company and Securities Law Journal* 101 at 112.

70 The *Financial System Inquiry Final Report* at 278 indicated that submissions raised a number of concerns about the existing regime for the regulation of financial markets, namely:

- "*incomplete coverage* - the Corporations Law does not apply to transactions falling outside strict definitions of ‘securities’ or a ‘futures contract’, including spot foreign exchange transactions and some OTC derivatives;
- *inflexibility* - the narrow definitions of ‘securities’ and ‘futures contract’ have required legislative amendments to permit exchanges to trade new products;
- *uncertainty and inconsistencies* - in the legal treatment of hybrid products with both security and derivatives characteristics (such as deliverable share futures and low exercise price options); and
- *barriers to entry* - retail consumers are effectively prohibited from transacting in OTC futures markets".

71 Recommendation 4.

72 s 1127.

73 *Financial System Inquiry Discussion Paper* at para 5.31.

all financial market brokers, whether the brokers deal in securities or derivatives, act for wholesale or retail clients, or transact on- or off-exchange.

2.51 Also, the proposed licensing system for the OTC market would introduce competence and integrity standards for OTC brokers, OTC advisers and those OTC market-makers who deal with retail end-users.

Retail participant protection

2.52 The Advisory Committee anticipates that there will be an increasing level of retail participation in the derivatives market as products originally designed for the wholesale market are adapted for retail end-users.[74] For this reason, some statutory protections are warranted to assist retail end-users to make properly informed decisions, without, however, attempting to insulate them from the financial risks of these decisions. This raises two inter-related matters:

- the tests for distinguishing between retail and wholesale participants, and
- the appropriate protections for retail participants.

Distinguishing retail and wholesale participants

2.53 *Tests for distinction.* The Advisory Committee agrees with the Financial System Inquiry that there is no universally accepted definition of retail participants in the financial market, nor criteria to distinguish wholesale and retail end-users.[75] Different definitions may apply for different activities.[76] However, in the derivatives context, the same tests for distinguishing wholesale and retail end-users should apply to the on-exchange and OTC markets.

2.54 The UK rules draw a three-way distinction between private customers (individuals and small business investors), non-private customers (ordinary business investors and experts) and non-customers of firms (primarily wholesale counterparties). The greatest obligations are owed by firms to private customers, and the least to their non-customers.[77] These categories are mainly distinguished by asset thresholds. However, the UK rules also apply knowledge and experience criteria. Furthermore, some persons can choose their own classification, or be classified by the firm with whom they are dealing if they do not object.[78]

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74 *Financial System Inquiry Final Report* at 110 noted that through technology "financial products can be developed more quickly, with greater sophistication, and tailored to individual needs. Innovations which often begin at the wholesale level can more quickly flow to retail users. Products, such as capped home loans and leveraged equity investments incorporating put options, are examples of innovations which began in the wholesale markets and are now being applied to retail products".

75 *Financial System Inquiry Discussion Paper* at para 5.54, *Financial System Inquiry Final Report* Chapter 7 footnote 3 (at 238) and 279-280.

76 For instance, the prospectus provisions of the Corporations Law set a threshold of $500,000 to distinguish between retail and wholesale investors, for the purposes of exempting the latter: s 66(2)(a), (3)(a), (ba).

77 *CASAC Research Paper* at 88-89.

78 *CASAC Research Paper* at 64-70.

2.55 The Advisory Committee supports asset and status tests to distinguish wholesale and retail end-users, though preferably they should be less complex than the UK approach. These tests would also be simpler to apply than some other criteria that have been suggested, such as the monetary size of each transaction (assessed, for instance, on the nominal gross amount of the contract, the initial outlay (if any), or the expected outlay) or the nature of the risk being faced (hedging or speculation).

2.56 The Advisory Committee considers that the asset and status tests used to identify wholesale end-users in the securities market should also apply in the derivatives context. Wholesale participants would include licensees, insurance companies, banks, larger superannuation funds and collective investment schemes, non-bank financial institutions, public authorities, investment companies and various foreign entities.[79] In addition, in the derivatives market:

- all listed companies should be wholesale end-users
- all remaining companies (public and proprietary) should be classified as wholesale or retail by applying to them the various tests currently used to distinguish between large and small proprietary companies.[80] However, small related companies of listed companies should be able to "opt up" to being wholesale end-users, by the board of directors providing a certificate stating that it has formed the view that the corporate entity has the experience and knowledge to undertake transactions in the wholesale derivatives market and is fully aware of the risks of so transacting.[81] It would be the responsibility of the directors of any body corporate providing

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79 ASC Policy Statement 121.17-20 classifies the following persons as wholesale in the securities context:
(a) a holder of a dealers or an investment advisers licence or an exempt dealer or investment adviser (as defined in s 68)
(b) a body corporate registered under the Life Insurance Act 1995
(c) a bank as defined in s 5 of the Banking Act 1959 or a bank constituted by or under a law of a State or Territory
(d) a trustee of a superannuation fund, an approved deposit fund or a pooled superannuation trust within the meaning of the Superannuation Industry (Supervision) Act 1993 that has more than 100 members
(e) a trustee or management company of a prescribed interest scheme (other than a scheme under (d)) which has net assets of not less than $10,000,000 and more than 100 members
(f) a trustee or management company of prescribed interest schemes when the trustee or management company has aggregate funds under management of not less than $50,000,000 and for each scheme under management there is:
  (i) not less than $10,000,000 funds under management; and
  (ii) more than 50 members
(g) a financial institution, building society or credit union under the Australian Financial Institutions Commission (AFIC) Codes
(h) an exempt public authority (s 9 definition)
(i) an "investment company" as defined in Corp Reg 7.3.12(3); and
(j) a foreign entity which is registered under comparable overseas legislation (for instance, a registered US broker-dealer or a foreign life company or bank).

80 s 45A. See also ASC Accounting Commentary 75.

81 IBSA *OTC Submission*.

that certificate to satisfy themselves of these matters. The directors should be required to disclose that certification in the annual report[82]

- brokers or advisers who do not satisfy any other wholesale participant test should be permitted to "opt down" from wholesale to retail.[83] This reflects the variety of types of licensees, including single purpose licensees who may not have the broad experience to be treated as professionals for all purposes

- all natural persons, other than licensees, regardless of their net worth, should be retail end-users. The Advisory Committee agrees with the ASC that natural persons of high net worth may not necessarily have the appropriate experience and expertise to be treated as wholesale financial markets participants, and may lack the capacity to seek their own remedies[84]

- the ASC should have an exemption or modification power to avoid the distinction between wholesale and retail end-users being entrenched in black letter law. This would allow the ASC to adjust to new practices in the market place.

2.57 Retail end-users (other than small related companies of listed companies who choose to "opt up") should not have the right to elect to be wholesale end-users and thereby forfeit their regulatory protections. Licensees who attempt to persuade retail end-users to incorrectly classify themselves as wholesale end-users could be disciplined through licence controls.

2.58 *Procedure for classification.* The Corporations Regulations could contain a prescribed form setting out the objective tests for being a wholesale or retail end-user, to be completed by new clients of licensees. Licensees would have no duty to independently assess the status of these clients.[85]

2.59 A licensee could rely on the prescribed form or any corporate certificate, subject to any later amendments that are notified to the licensee. This would overcome any obligation on licensees to continually monitor the status of the end-user.

2.60 The Advisory Committee recognises the need to clarify the regulatory implications of persons changing their classification from wholesale to retail, particularly during the course of ongoing derivatives transactions. The retail end-user protections, in particular the "know your client" requirement, should only apply prospectively. Thus, persons who notify their change of status from a wholesale to a retail end-user during the course of ongoing derivatives transactions would not be entitled to the statutory "know your client" protection for any derivatives transactions

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82 AFMA *OTC Submission*, ANZ *OTC Submission*.

83 cf ASC Policy Statement 121.17(a).

84 cf ASC Policy Statement 121.19.

85 This would overcome a concern in a number of submissions to the OTC DP that OTC participants might be required to assess the characteristics of their counterparties.

already entered into. That protection would only apply to any personal derivatives recommendations subsequently made to the retail end-user.

2.61 In summary, the self-assessment test could apply as follows:

- a prescribed form to set out objective tests
- an obligation on end-users to classify themselves by completing the form
- no obligation on licensees to independently assess the status of their clients
- self-classification to remain unless or until further notification to licensee (any changes in status not to have a retrospective effect).

Distinction between wholesale and retail participants

Recommendation 1. The legislation should distinguish between wholesale and retail participants in derivatives markets. The following persons should be classified as wholesale participants in derivatives markets:

- all persons classified as wholesale in ASC Policy Statement 121
- all listed companies
- related companies of listed companies that "opt up" to being wholesale end-users by resolution of the board of directors
- large proprietary companies.

Brokers or advisers who do not satisfy any other wholesale participant test should be permitted to "opt down" from wholesale to retail.

Protecting retail participants

2.62 The Advisory Committee considers that the regulatory framework for derivatives needs to take into account the differences in the level of commercial sophistication and financial means between retail and wholesale end-users and apply some particular disclosure and other protections to retail end-users only. This goal can be achieved without interfering with wholesale derivatives activity, or requiring a fundamental regulatory division between wholesale and retail derivatives markets. The Financial System Inquiry took a similar view.[86]

2.63 *On-exchange.* There are no restrictions on retail participation in the on-exchange derivatives market.

2.64 Market stability is strengthened by the requirement that brokers trading on behalf of retail end-users remain liable as principals. The ability of retail end-users to honour their futures contracts commitments is monitored by clearing house margining requirements. The clearing house structure also protects the counterparty against counterparty credit risk through the novation process.

86 The *Financial System Inquiry Final Report* at 244 noted that the ASC currently performs market integrity and consumer protection functions for wholesale and retail transactions respectively. The Inquiry "did not receive compelling evidence to suggest that these functions would be better carried out separately".

2.65 *OTC.* Retail end-users may differ from wholesale participants in having:

- less knowledge, experience or expertise in OTC products
- less capacity to assess counterparty credit risk
- fewer funds to satisfy their OTC commitments, and
- fewer resources to enforce legal remedies in the event of default by their counterparties.

2.66 This raises the issue whether retail end-users should be permitted to trade in the OTC market, given the lack of any clearing house controls or other contract protections comparable to those for on-exchange trading. The key regulatory concern is whether some restrictions should be imposed on retail participation to protect the OTC market, given that retail end-users may generate considerable counterparty credit risk. Currently, there is a prohibition on retail participation in exempt futures markets.[87]

2.67 In the OTC DP, the Advisory Committee set out a series of possible restrictions on the participation of retail end-users in the OTC market. They included:

- confining retail end-users to less exotic or less complex OTC derivative products, given their probable lack of derivatives expertise. However, this raises a number of regulatory concerns including that:
  - there is no clear division between "plain" and "exotic" products
  - retail end-users may be unduly disadvantaged by being denied particular derivative products
  - exotic derivatives could be replicated by using combinations of other, permitted, derivatives
  - retail end-users can sustain substantial losses even on "plain" derivatives
  - the contractual rights of retail end-users and counterparties who enter into prohibited exotic products would be uncertain
  - to impose a prohibition would require a continuing regulatory role to classify new products as plain or exotic and enforce the prohibition.

- requiring that retail end-users have a good credit rating, at least for contingent liability OTC derivatives which may require end-users to meet further financial obligations. Some OTC derivatives markets could be conducted in this manner. However, any legislative prescription of this nature may eliminate many retail end-users from the OTC market.

- limiting retail end-users to "non-contingent liability" obligations,[88] except under OTC contracts entered into with a licensee or other wholesale counterparty. This restriction is directed at the possible lack of financial

87 ASC Policy Statement 70. The ASC adopted this prohibition in response to its concern about the lack of sufficient safeguards for retail end-users in OTC markets.

88 These are transactions where the retail end-user is only required to make a single complete payment at the commencement of the transaction.

resources of retail end-users to meet their potential liabilities. The wholesale counterparty could assess the creditworthiness of the retail end-user for contingent liability transactions. This would also reduce counterparty credit risk for retail end-users (given the proposal that OTC market-makers would be subject to prudential risk management and capital controls). However, this option would restrict the possible types of transactions between retail counterparties. Uncertainties would also arise as to the legal consequences of entering into prohibited contingent liability transactions.

- limiting retail end-users to hedging rather than speculative OTC transactions. For instance, AFIC restricts the use of derivatives by building societies and credit unions to reducing market risk. The same general approach is taken in the UK.[89] Problems include the difficulty of clearly distinguishing between hedging and speculation and how to enforce such a restriction in the OTC market.

- limiting OTC transactions to persons who have specifically opted out of the risk disclosure and "know your client" protections otherwise afforded to retail participants. This would put undue pressure on those retail participants who wished to transact in the OTC market to forgo the protections proposed for them.

- banning transactions between retail end-users. In consequence, retail end-users could transact only with wholesale counterparties. Several submissions supported prohibiting OTC retail end-users from entering into derivatives transactions with each other or requiring at least one counterparty to all OTC transactions to be a licensee or other wholesale participant.[90] This approach would enhance market stability by protecting retail end-users from the increased possibility of loss through transacting with other retail end-users. It may reduce the possible overall level of failure in the OTC market and any adverse contagion effects. However, banning retail-to-retail OTC transactions could be difficult to enforce and would leave unresolved the legal status of prohibited transactions.

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89 The UK legislation restricts retail participation in the OTC derivatives market. A UK firm is prohibited from effecting, arranging or recommending an OTC contingent liability transaction to a private customer unless there is a two way customer agreement and the firm reasonably believes that the purpose of the transaction is to hedge against currency risk. UK Investment Management Regulatory Organisation (IMRO) Consultation Document 33 *Derivatives* (November 1996) para 2.18 proposed that this prohibition should remain except for OTC transactions where the purpose is to hedge against either currency or interest rate risk relating to a private customer's existing exposure.
The UK restriction on non-exchange-trading by retail end-users recognises that OTC transactions can be riskier for retail participants than on-exchange transactions, given that the usual exchange protections of price transparency, margining and novation clearing do not apply. Also, those OTC derivatives that have potentially unlimited risk may rarely be appropriate transactions for retail end-users: id at paras 2.16-2.17.

90 AFMA *OTC Submission*, ANZ Banking Group *OTC Submission*, Coopers & Lybrand *OTC Submission*, John O'Sullivan *OTC Submission*, Westpac *OTC Submission*.

2.68 The Advisory Committee supports, in principle, the right of retail persons to participate in OTC derivatives markets, provided that they are properly protected. In these circumstances, it agrees with the Financial System Inquiry that the existing prohibition on retail participation in exempt futures markets should be discontinued.[91] Any regulatory restriction could artificially restrict freedom of contract and therefore be potentially detrimental to the economic interests of retail end-users. It would also be difficult to enforce. Likewise, the legal status of affected contracts would be uncertain.

2.69 While the Advisory Committee supports retail participation in the OTC derivatives market, it recognises that there would most likely be considerable differences between the knowledge, experience or judgment of financial institutions and that of retail clients or counterparties. This information asymmetry justifies:

- creating a separate category of financial markets licence for those OTC market-makers who deal in derivatives with retail end-users, with competence and integrity as well as prudential requirements for these licensees[92]
- requiring client agreements for retail clients,[93]
- providing retail end-users with an Advisory Services Guide,[94] complaint resolution procedures for their dealings with OTC brokers, OTC market-makers who deal with retail end-users and on-exchange and OTC advisers,[95] derivatives risk disclosure[96] and "know your client" protections[97] and
- ensuring that any deposit or margining funds or property provided by a retail OTC end-user to a counterparty are held in trust, notwithstanding any contrary terms in the OTC derivatives agreement.[98]

2.70 The Financial System Inquiry also supported the principle of there being an additional layer of consumer protection for retail OTC end-users, compared with

91 *Financial System Inquiry Final Report* Recommendation 20. Currently, ASC Policy Statement 70 prohibits retail participation on exempt futures markets declared under s 1127. The ASC adopted this prohibition in response to its concern about the lack of sufficient safeguards for retail end-users in OTC markets. However, the ASC *Submission* in March 1995 to the Parliamentary Joint Committee on Corporations and Securities Derivatives Review stated (at para 44) that: "the current policy of requiring retail derivative dealings to take place only on exchange markets is not tenable in the long term. Provided that appropriate safeguards can be developed for retail participation in OTC markets (possibly including limitations on the types of products that may be sold to retail participants), the ASC believes there should be a relaxation of the on-exchange trading requirement."

92 Recommendation 22. Compare ss 1144A(2), 1145(4). In particular, the ASC must have no reason to believe that the person is not of good fame and character or that the person will not perform the person's duties efficiently, honestly and fairly.

93 Recommendation 28.

94 paras 5.92-5.93, post.

95 paras 5.90-5.91, post.

96 Recommendation 29.

97 Recommendation 31.

98 Recommendations 38 and 39.

wholesale OTC market participants.[99] For instance, it proposed that the Commission facilitate the creation of a central complaints referral service for all consumers of retail financial products and services, funded by retail financial service providers on a cost recovery basis.[100]

2.71 These retail safeguards would not interfere with the workings of the Australian wholesale OTC market or affect its international competitiveness. Also, the limited ambit of the retail protections for the OTC derivatives market would not justify any fundamental regulatory split between wholesale and retail OTC derivatives markets regulation or regulators. The Advisory Committee does not propose a regulatory division of this nature. The Financial System Inquiry took a similar view.[101]

2.72 The Advisory Committee supports abolishing regulatory barriers to retail participation in OTC derivatives markets, subject to the safeguards described above. However, this would not prohibit the setting up of wholesale-only OTC derivatives markets which exclude retail participation.[102]

Retail participation in OTC derivatives markets

Recommendation 2. There should be no regulatory restrictions on retail participation in OTC derivatives markets, provided the safeguards for retail end-users recommended in this Report are implemented.

Trading integrity

2.73 Derivatives market regulation should seek to reduce or forestall the possibility of misleading, manipulative or other market abuse or distortion practices taking place on either the on-exchange or OTC derivatives markets. These practices may impair efficient price discovery, reduce public confidence in a market's fairness and thereby detrimentally affect market participation and depth. The Advisory Committee elsewhere in this Report recommends reforms of the current market manipulation provisions to apply them to OTC, as well as on-exchange, derivatives markets.[103]

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99 *Financial System Inquiry Final Report* Recommendation 20.

100 *Financial System Inquiry Final Report* Recommendation 25.

101 *Financial System Inquiry Final Report* at 244-245.

102 For instance, a wholesale-only OTC derivatives market might be established for trading in fungible derivatives: refer para 4.23 ff.

103 Recommendation 46.

Chapter 3. Derivatives in the Australian financial system

This Chapter analyses derivatives regulation in the broader context of Australian financial markets. It explains the functions and benefits of core financial markets regulatory criteria and the need, within these core criteria, to distinguish between derivatives and securities markets and products for certain purposes.

Uniform financial markets regulation

3.1 The Australian on-exchange and OTC derivatives markets are an integral part of the overall Australian financial system. There have been calls for more consistent regulation of all financial market instruments or products in that system, including securities and derivatives, given their converging economic functions.

3.2 The Parliamentary Joint Committee on Corporations and Securities, in its 1995 *Report on Derivatives*, concluded that:

> "the division of the regulation of [financial] markets into two separate chapters of the Corporations Law [Chapter 7 (securities) and Chapter 8 (futures contracts)] appears to be inappropriate ... The Committee believes ... that Chapters 7 and 8 should be reviewed and replaced with a more appropriate single regulatory structure".[104]

3.3 A subsequent Treasury Paper proposed consistent functional regulation for all financial markets instruments, including securities, futures contracts, options and other derivatives. The Paper favoured a single financial markets regime, in substitution for the current regulatory distinction between Chapter 7 securities and Chapter 8 futures contracts. An approved financial exchange could trade any financial instrument, provided that the business rules make appropriate provision for trading that product. This uniform regulatory regime would also permit a single licensing system for financial market participants and uniform disclosure standards and market conduct requirements.[105]

3.4 This uniform financial markets approach is also reflected in the Commonwealth Government's *Corporate Law Economic Reform Program*, which is designed to give corporate law a much stronger economic focus.

3.5 The SFE has supported the principle of a common regulatory structure for financial products, including securities and derivatives. It proposes greater use of a generic core rules concept for financial markets activity, supported by more specific or supplementary rules applying to narrower classes of derivatives or securities activity, where necessary.[106]

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104 Parliamentary Joint Committee on Corporations and Securities *Report on Derivatives* (20 November 1995) at para 4.4.

105 *Treasury Paper on Regulation of Securities and Derivatives* (October 1996).

106 *SFE Supplementary Submission to the Financial System Inquiry* (December 1996).

3.6 The ASX has put forward a similar model for regulation of financial markets. It proposes a single authorisation procedure for financial exchanges, regardless of whether they conduct a market in securities, derivatives or both. This would encourage greater competition between authorised exchanges. The concept of derivatives and securities should only remain for limited regulatory purposes, for instance, disclosure requirements and clearing arrangements. Within that overall financial markets framework, the tailoring of details could be left to the ASC, the exchanges and other financial markets industry bodies.[107]

3.7 The Financial System Inquiry recommended that the Corporations Law be reformed in various ways to keep pace with innovations in financial markets, including:

- a "principles-based" approach to financial markets regulation
- a generic definition of "financial products" to replace existing separate Corporations Law regulation of securities and futures contracts
- generic requirements for these financial products, supplemented by specific regulation for particular classes of products
- a single authorisation procedure for financial exchanges
- a broad power for the regulator to declare whether particular products fall within the financial markets regime or are exempt
- a single licensing regime for financial markets intermediaries.[108]

3.8 The Advisory Committee supports the Corporations Law focusing on financial markets and their products, by identifying common features and regulating them in a uniform manner. Within that core financial markets regulatory framework, there would need to be supplementary provisions which, for certain limited purposes, distinguish between derivatives and securities, and between on-exchange and OTC markets.

Role of core financial markets regulation

Benefits of core regulation

3.9 Appropriate use of a core regulatory approach in Australia for financial markets and the instruments traded on those markets, including securities and derivatives, could:

- clarify and simplify the law, thereby reducing uncertainties and compliance costs

- avoid regulatory overlaps or gaps

- facilitate the development of new products by eliminating unnecessary differences in the way products are regulated

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107 *ASX Supplementary Submission to the Financial System Inquiry* (January 1997).

108 *Financial System Inquiry Final Report* Recommendations 13, 19 and 21.

- reduce regulatory arbitrage, that is, artificially designing products to take advantage of different regulatory regimes, and

- increase the compatibility of Australian and overseas financial markets regulatory regimes.

UK approach

3.10 A useful overseas model is the UK Financial Services Act (FSA). This legislation applies to all "investments", defined to include securities, derivatives and collective investments.[109] It regulates all persons (firms) who, in the UK, deal in, manage or advise on investments, and provides a range of protections for different classes of clients of these firms.[110] It also imposes general licensing and prudential controls on these firms.[111] However, within this core regulatory structure, regulatory distinctions between derivatives or contingent liability transactions and other investments still remain for some purposes, including margining rules, customer agreement requirements and risk disclosure statements.[112] Also, the prospectus requirements only apply to securities.[113] Furthermore, the FSA does not directly regulate the structure of, and conduct on, derivatives and securities exchanges.

Advisory Committee approach

3.11 There are a number of core regulatory matters that are common to Chapters 7 (securities) and 8 (futures contracts) of the Corporations Law, including:

- controls on the conduct of unauthorised securities or futures markets
- a co-regulatory framework for the regulation of exchanges
- the licensing of market intermediaries
- protecting clients' assets
- the establishment of compensation funds to cover losses through defalcation of exchange members
- controls over insider trading, market manipulation and other abusive conduct, and
- ASC investigative and enforcement powers.

3.12 The Advisory Committee adopts a core financial markets regulatory approach in its discussion of the regulation of derivatives markets,[114] a single authorisation procedure and co-regulatory structure for financial exchanges[115] and a single financial

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109 *CASAC Research Paper* at 61-64.

110 *CASAC Research Paper* at 64-70 sets out the tests for the three different classes of clients (private customers, non-private customers and non-customers). The protections given to each class are summarised at 88-89.

111 *CASAC Research Paper* at 71, 82-83.

112 *CASAC Research Paper* at 70-76.

113 *CASAC Research Paper* at 78-79.

114 Chapter 4, para 4.1 ff, post.

115 Chapter 4, para 4.42 ff, post.

markets licensing system.[116] The licensing system could introduce common regulatory arrangements, such as risk-weighted capital standards for dealers and brokers, given that both derivatives and securities trading can generate financial risks, though the extent of risk (and therefore the actual capital requirements) is usually greater with derivatives.[117] Overseas markets are moving in that direction. Likewise, many of the statutory rules governing the relationship between brokers and their clients, including the protection of client assets, could be uniform within all financial markets. Also, with some adjustments for differences between securities and derivatives, the Advisory Committee proposes similar controls over insider trading, market manipulation and other abusive conduct. Finally, the ASC's investigative and enforcement powers should apply equally to all financial markets and transactions.

3.13 Consideration of a core regulatory structure for all financial markets is also relevant in assessing current regulatory issues. For instance, securities advisers, but not futures advisers, are subject to statutory "know your client" obligations, for the benefit of their clients, wholesale as well as retail.[118] There is a strong argument that wholesale end-users in any financial market do not need the benefit of a "know your client" rule. It is more appropriate that the protection should be directed at retail end-users. This suggests that any uniform "know your client" rule should apply to all financial market advisers, but only for personal recommendations they provide to their retail clients.

Role of supplementary regulation

3.14 In addition to the core financial markets regulation, there need to be supplementary provisions which, for certain purposes, distinguish between derivatives and securities regulation and between on-exchange and OTC market regulation.

Distinguishing between derivatives and securities regulation

Differences between on-exchange derivatives and securities markets

3.15 The Advisory Committee recognises that the economic purpose and effect of some exchange-traded derivatives and securities are increasingly converging.[119] Market participants may employ securities, or derivatives over securities, to achieve similar economic objectives or economically equivalent positions. Derivatives can be used to synthesise a securities position, for instance through an equity swap or share futures or hedge against adverse movements in the physical market. Nevertheless, some risks materially differ, given the different transaction procedures in these markets.

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116 Chapter 5, post.

117 The risks in securities transactions are usually short-term (that is, the transactions are quickly settled) whereas the risks in derivatives transactions can be long-term (that is, transactions can contemplate months or years before settlement).

118 s 851.

119 For instance, deliverable share futures, like the shares themselves, permit participation in any increased value in these shares, but without the need to buy and sell the shares. Also, persons may, in effect, purchase shares by acquiring (and subsequently requiring physical delivery of) deliverable share futures with an imminent settlement date.

3.16 On-exchange derivatives contracts may involve the parties in long-term performance or financial commitments, which may be magnified by leverage[120] and changes in the market value of the underlying. In general, there are no equivalent long-term commitments with on-exchange share transactions, given that these transactions are usually settled promptly and with no continuing financial obligation.[121] Derivatives clearing arrangements, but not securities clearing arrangements, need to deal with this longer term and variable risk. For on-exchange derivatives, this can be dealt with through contract protection arrangements, such as clearing house margining requirements. Conversely, it would be unnecessary and inappropriate to impose margin based clearing on share trading.

3.17 For these reasons, a regulatory distinction still needs to be drawn, within the core financial markets context, between derivatives markets and securities markets.

Other differences between derivatives and securities

3.18 Regulatory distinctions between derivatives and securities also need to be drawn in other key areas, namely:

- *prospectus requirements.* These requirements are applicable to primary issuers of securities but not derivatives. The value of securities depends heavily on the performance and prospects of the business carried on by the issuer, as known to, and described by, that issuer in the prospectus. By contrast, the value of a derivative arises from some asset, rate or index, independently of the issuer. Relevant information is not in the unique possession of the issuer of the derivative

- *risk disclosure.* The generic risks of derivatives trading (and the difference between on-exchange and OTC derivatives trading) are materially different from those of securities trading, and require a different risk disclosure regime. For instance, participants in derivatives transactions may lose their initial margin plus additional amounts which cannot be quantified at the time of entering into the transaction. This risk disclosure would be unnecessary and misleading for securities transactions

- *transfer of title rules.* These rules are necessary for marketable securities, but not for most derivatives. They would only apply to those derivatives that may result in the physical delivery of securities

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120 A derivatives transaction is leveraged where the initial consideration for entering into the transaction is considerably less than the face value of the subject matter of the agreement. This allows a party to maintain a derivatives transaction without necessarily having to pay its full face value. However, depending on any variations in the value of the subject matter, a party may incur an additional liability. In effect, leverage magnifies the potential for profit or loss.

121 Currently, final settlement of on-exchange equity transactions must take place within five days of each trade. The ASX aims to reduce this to international best practice (three days after trade) by the end of 1997.

- *licensing requirements.* The authorisation requirements for financial markets licences may still need to distinguish between derivatives and securities. For instance, a licensee might have the requisite knowledge and skills to transact in securities and derivatives of securities, but not other derivatives. Also, the proposed prudential requirements for those financial markets licensees who are authorised as OTC derivatives market-makers may not be necessary for those licensees who deal only in off-exchange securities transactions.

3.19 There are other areas where a regulatory distinction between derivatives and securities is still relevant. For instance, the ultra vires issue[122] may arise in the context of derivatives, but usually not securities, trading. Likewise, there is a stronger argument for giving additional supervisory information-gathering powers to a regulator in regard to OTC derivatives than in regard to off-exchange securities dealings, given the considerable size and international character of the OTC derivatives market.

Distinguishing between on-exchange and OTC market regulation

On-exchange and OTC derivatives markets

3.20 On-exchange and OTC derivatives markets are, to some extent, economically and commercially interdependent. For instance, participants may reduce their OTC derivatives risks, even in volatile or illiquid OTC markets, by entering into hedging or offsetting derivatives transactions in the more liquid on-exchange market. Conversely, a loss of liquidity in on-exchange markets could result in substantial unanticipated trading losses for those OTC market participants who have assumed an ability to promptly offset any OTC derivatives exposures in this way. Also, some forms of derivatives transactions employ both on-exchange and OTC markets. For instance, warrants are transacted on-exchange, but are eventually settled OTC.

3.21 However, the economic interrelationship between the on-exchange and OTC markets is nevertheless offset by some significant differences between them, which must be taken into account in developing an appropriate regulatory structure. These differences are summarised below.

- Exchange-traded derivatives have fully standardised terms.[123] This helps to generate market depth. By contrast, transactions on OTC derivatives markets are typically individually negotiated principal-to-principal arrangements. This permits counterparties to tailor the terms and settlement dates of derivatives transactions to meet their specific requirements.

122 para 8.95 ff, post.

123 For instance, the contract terms of exchange based futures contracts, describing the contract size, delivery grade, delivery location, and delivery dates (if delivery is contemplated) are fully standardised. Only the price is left to be determined.

- The on-exchange market provides a significant public price discovery function for standardised derivatives. There is currently no equivalent public mechanism in the customised OTC derivatives market.

- On-exchange derivatives markets typically deal with the risk of counterparty default (counterparty credit risk) through novation clearing and margining arrangements, supported by back-up financial resources.[124] These clearing arrangements transfer counterparty credit risk from the participants to the clearing house (and its members collectively). By contrast, participants in the OTC derivatives market must rely on the continuing ability of their counterparties to meet their obligations. This difference in responding to counterparty credit risk might justify the imposition of prudential controls (risk management and capital requirements) on those principals in the OTC derivatives market who are market-makers, given that:

  - they may bear considerable counterparty credit risk in their derivatives market-making role, and
  - their continuing solvency is important for the overall stability of the OTC derivatives market.

- Participants in the OTC derivatives market incur the risk that their counterparties' performance obligations may be legally unenforceable. This may arise, for instance, from the legal documentation being inadequate or unenforceable (particularly in cross-border transactions) or from a counterparty lacking the power to enter into transactions (ultra vires). Currently, there is no equivalent legal documentation problem in the on-exchange derivatives market, while the ultra vires risk is assumed by the brokers who act as principals in all transactions on that market.

On-exchange and OTC markets generally

3.22 Some differences between on-exchange and OTC markets may apply equally to securities and derivatives markets and need to be reflected in any regulatory proposals. For instance, securities advisers, but not futures advisers, must disclose to their clients any pecuniary or other interests which may affect their recommendations.[125] In principle, the same benefits disclosure rule should apply to all persons who advise on on-exchange transactions. However, a similar benefits disclosure rule (or a conflict of interest disclosure rule) might be unsuitable in OTC markets, given that it is common practice for OTC advisers (or their related entities) to be counterparties to the OTC transactions they recommend. At a minimum, any benefit disclosure rule for the OTC market should exempt actual or expected profit from the adviser being the counterparty to the transaction.

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124 Currently the Sydney Futures Exchange Clearing House (SFECH) financial backing is approximately $100 million. The National Guarantee Fund (NGF), administered by a subsidiary of the ASX, has total funds of over $140 million, to cover its on-exchange securities and equity derivatives transactions.

125 ss 849, 850.

Structure of the Corporations Law

3.23 The Advisory Committee supports the Corporations Law being redesigned to introduce core financial markets provisions, dealing, for instance, with financial exchange authorisation and financial markets licensing.

3.24 These core provisions should be supplemented by regulatory distinctions, for limited purposes, between securities and derivatives markets and transactions, and between on-exchange and OTC markets. The Advisory Committee has considered two alternative structures for these supplementary provisions.

- *Option A: market distinction:* combine the supplementary provisions for on-exchange securities and derivatives transactions and separately combine the supplementary provisions for all OTC securities and derivatives transactions

- *Option B: product distinction:* combine the supplementary provisions for on-exchange and OTC securities transactions and separately combine the supplementary provisions for all on-exchange and OTC derivatives transactions.

3.25 The Advisory Committee considers that Option A would be unsatisfactory as:

- combining exchange-traded securities and derivatives supplementary provisions would obscure some important differences between on-exchange derivatives and securities markets, including the different purposes of any clearing arrangements. Securities clearing arrangements deal with transfer of property rights whereas derivatives clearing arrangements deal with counterparty credit risk

- much of the law dealing with securities would apply equally to on- and off-exchange transactions. This could lead to considerable duplication under Option A

- the prospectus provisions would apply to on- and off-exchange securities, but not to any derivatives contracts[126]

- given the difference in risks between securities and derivatives transactions, the rules for regulating off-exchange derivatives transactions (particularly for retail persons) would need to differ from those for off-exchange securities transactions.[127]

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126 In primary markets for shares and debentures, the prospectus requirements are imposed on the issuer of the security. There is no equivalent issuer for derivatives contracts (other than for warrants).

127 ASC Policy Statement 105 deals with secondary trading of unquoted securities.

3.26 The Advisory Committee prefers Option B, which avoids these problems by drawing a general regulatory distinction between fundraising and risk management arrangements in relation to the supplementary provisions. The derivatives supplementary provisions could be subdivided into two sections, one dealing with on-exchange, the other with OTC, transactions.

Core financial market provisions

Recommendation 3. The Corporations Law should have core provisions for the regulation of financial markets and financial market instruments, with supplementary provisions that, for certain limited purposes, distinguish between:

- derivatives and securities, and
- on-exchange and OTC markets.

Definition of derivatives

On-exchange and OTC

3.27 The proposed restructuring of the Corporations Law into core financial market and supplementary provisions would require a definition of derivatives, at least for the purposes of those supplementary provisions. Currently, the Corporations Law does not refer to derivatives. The Advisory Committee considers that this term should be included, and defined, in the Corporations Law.

3.28 One approach is to base a definition of derivatives on the existing "futures contract" definition[128] and elements of the "securities" definition,[129] together with the current exclusions in s 72(1)(d). However, this approach presents a number of problems including:

- the difficulties of interpretation arising from the relevant case law on the meaning of "futures contract"[130]
- the regulatory gaps in the existing legislation[131]
- the difficulties in classifying options[132]
- other difficulties in s 72(1)(d).[133]

3.29 An alternative approach is to develop a new definition that focuses on the commercial nature of derivatives and is applicable to both on-exchange and OTC derivatives transactions. This approach would:

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128 *CASAC Research Paper* at 7-17.

129 *CASAC Research Paper* at 17-19.

130 *CASAC Research Paper* at 10 ff. See also *SFE Ltd v ASX Ltd* (1995) 16 ACSR 148.

131 See OTC DP para 0.41.

132 *CASAC Research Paper* at 23-26; M Starr, "Options: Is compliance with derivatives regulation optional?" [1995] *Butterworths Corporation Law Bulletin* No 7 at [136].

133 *CASAC Research Paper* at 21-22.

- overcome current differential regulation for products with the same economic characteristics and risk management functions, depending on whether they are futures contracts, securities or neither

- resolve uncertainty about the categorisation of some derivatives products under the existing definitions[134]

- reduce the risk that the definition, and its regulatory consequences, will become obsolete

- permit product innovation on a more predictable regulatory basis, and

- facilitate appropriate supervision of derivatives markets as a whole.

Methods for developing a derivatives definition

3.30 Any definition of derivatives must be broader than "futures contracts" as defined in the Corporations Law, as:

- the futures contract definition originally sought only to cover those classes of derivatives transactions that should be transacted on an approved futures exchange, or an exempt futures market[135]

- the Full Federal Court decision in *SFE v ASX* has reduced the possible ambit of the futures contract definition[136]

- the standardisation requirement (used in defining some categories of futures contracts[137]) and the statutory exceptions from the futures contract definition[138] are irrelevant in developing a general derivatives definition, as they were introduced to exempt various customised OTC derivatives transactions from the futures contract definition

- derivatives such as deliverable share futures, deliverable bond futures and options over them, appear to fall outside the futures contract definition.[139]

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134 *CASAC Research Paper* at 21-27.

135 The "on-exchange" requirement (s 1123) sought to prohibit various types of off-exchange "bucketing" activities prevalent in the early to mid-1980s. Bucketing involved the failure of a broker to comply with a client's instructions to execute trades on-exchange. The exception is exempt futures markets (s 1127). This category may have originally been included primarily to permit the types of off-exchange transactions now covered by s 72(1)(d).

136 The Full Federal Court in *SFE v ASX* (1995) 16 ACSR 148 ruled that a LEPO was not a futures contract, for the reason, inter alia, that a share is not a commodity.

137 The concept of standardisation is used in "adjustment agreement" and "eligible commodity agreement": see further *CASAC Research Paper* at 10. This concept is now less useful in distinguishing between OTC and on-exchange markets, given the increasing use of standardised documentation, such as the AFMA/ISDA documentation, in the Australian OTC market. That documentation guides participants in settling the terms of derivatives contracts. This reduces transaction costs and assists in netting.

138 s 72(1)(d).

139 This follows from the decision in *SFE v ASX* (1995) 16 ACSR 148.

Special provisions have been required to enable these derivatives to be traded on the SFE.[140]

3.31 The Advisory Committee has considered two alternative methods for developing a general derivatives definition:

- *the inductive method*, that is, developing a definition from specific categories of transactions (for instance, by modifying the existing futures contract definition), with a power (by regulation or administrative discretion) to include further agreements to avoid under-regulation

- *the deductive method*, that is, devising a general broad definition to cover all possible derivatives, with a power (by regulation or administrative discretion) to exempt certain agreements, to avoid over-regulation.

An inductive definition

3.32 A derivative could be defined under the inductive method as any of the following:[141]

- *a financial adjustment agreement*, that is, an agreement for future performance of a type which is used for the purpose of securing a profit or avoiding a loss by reference to fluctuations in the value or price of property or other underlying of any description, not being a contract of insurance or an agreement where it is likely that the profit is to be obtained or the loss avoided by taking delivery of the underlying.[142] This definition is designed to cover all cash-settled contracts for differences

- *a tradeable commodity agreement*, that is, an agreement the effect of which is that a person is under an obligation to make delivery or a person is under an obligation to accept delivery at a particular future time of a particular quantity of property or other underlying of any description for a particular

140 Corp Regs Part 1.2 Divs 2-5.

141 This definition is proposed by M Starr, Policy Director, Government and Legislative Affairs, SFE, in his Paper, *Introduction to Derivatives* (NSW Young Lawyers Accounting and Derivatives Seminar 30 May 1996).

142 This is adapted from the definition of "contract for differences" in the Financial Services Act 1986 (UK). An alternative definition of financial adjustment agreement, adapted from the definition of "adjustment agreement" in the Corporations Law, could be "any agreement which has the effect that:

(a) a particular person will be under an obligation to pay or have a right to receive an amount of money;

(b) whether the person will be under such an obligation to pay, or have a right to receive, the money will depend on a particular state of affairs existing at a particular future time, including, without limiting the generality of the foregoing, a state of affairs that relates to fluctuations in the value or price of a commodity or other property, or in an index or other factor; and

(c) the amount of money will be calculated in a particular manner by reference to that state of affairs;

whether or not the agreement has any other effect or is capable of being varied or discharged before that future time".

price or for a price to be calculated in a particular manner, being an agreement where, at the time it is entered, it appears likely that the obligations relating to delivery will be effected otherwise than by delivery.[143] This definition is designed to cover those forward contracts which, though expressed to be deliverable, are unlikely to be settled by delivery

- *a tradeable option agreement*, that is, a contract under which a party acquires from another party an option or right, exercisable at or before a specified time, to buy or sell to that other party a specified amount or number of items of property or other underlying, being an agreement where, at the time it is entered, it appears likely that the option or right will be exercised otherwise than by delivery of the underlying.[144] This definition should exclude options issued by a company permitting the taker to subscribe for the company's unissued shares

- *a combination agreement*, that is, an agreement which incorporates the features of more than one of the above financial adjustment, tradeable commodity and tradeable option agreements

- *a declared agreement*, that is, an agreement declared by the ASC to be an agreement falling within a class that is otherwise commonly recognised as a derivative by financial institutions.

A deductive definition

3.33 A derivative could be defined under the deductive method as any agreement:

- the value of which is ultimately derived from, or varies according to, the value of one or more assets, rates, indices or other underlying (*derived value element*), and

- whereby one or both parties, at some future time, may have to provide cash or other consideration (excluding any initial or periodic consideration that is fixed at the time the agreement is entered into) to the counterparty or a substitute counterparty (such as the clearing house), that consideration ultimately being determined in whole or part by reference to the derived value element (*liability element*).

3.34 The deductive definition of derivative is broader than the current futures contract definition, as it covers:

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143 Whether delivery is likely would be assessed not by reference to the intentions of the parties but by reference to a range of other circumstances, including the rules and practices of the relevant market and the proportion of similar contracts which are closed out early by entry into offsetting contracts. Compare s 9 "eligible commodity agreement" (analysed in the *CASAC Research Paper* at 12).

144 This definition is intended to include only those options which, though expressed as being deliverable, are likely to be cash-settled having regard to market practice.

- eligible commodity agreements, whether or not physical delivery is likely[145]
- all current OTC as well as exchange-traded options (other than options issued by a company permitting the taker to subscribe for the company's unissued shares)
- all transactions currently exempt under s 72(1)(d).[146]

Advisory Committee view

3.35 The Advisory Committee sees merit in both approaches, which employ commercial criteria to overcome some of the complexities in the current Corporations Law definitions. Many respondents emphasised the need for a flexible and commercially based generic definition of derivatives to deal with dynamic markets and new products.[147] The principal difference between the two approaches is that the deductive definition seeks to cover all possible derivatives. This broad-ranging approach is intended to accommodate innovative derivatives products without creating any regulatory gaps or the need for amendments to the derivatives definition as new classes of derivatives arise. For these reasons, the Advisory Committee adopts the deductive definition in this Report.

3.36 To avoid the deductive definition being over-regulatory, the Corporations Regulations could set out specific classes of agreements that are not to be regarded as derivatives under that definition. Also, there should be a power to declare any other class of agreements not to be derivatives. The Financial System Inquiry recommended that the Commission should have the flexibility to declare certain products to be covered by, or be exempt from, the Law.[148] The Advisory Committee considers that this power should be limited, in the context of derivatives, to exempting products from the deductive derivatives definition.

Explanation of the proposed deductive definition

Derived value element

3.37 This element is the most commonly recognised feature of all derivatives. It is an essential explanatory element of any general derivatives definition. The derived value element can be based on any underlying. In practice, the most common forms of underlying are:

- a physical commodity
- a financial asset
- energy products
- an index, interest rate or currency

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145 The definition of "eligible commodity agreement" (one of the categories of "futures contract") is intended to cover deliverable contracts. However, delivery must be unlikely.

146 The definition would also cover all derivatives, quasi-derivatives and warrants under the UK Investment Management Regulatory Organisation (IMRO) rules: IMRO Consultation Document 33 *Derivatives* (November 1996) paras 2.2-2.3.

147 For instance, IBSA *OTC Submission*, ISDA *OTC Submission*, Phillips Fox *OTC Submission*, JP Morgan *OTC Submission*, Merrill Lynch *OTC Submission*, ASCT *OTC Submission*.

148 *Financial System Inquiry Final Report* Recommendation 19.

- another derivative.

3.38 The word "ultimately" covers derivatives over derivatives, including swaptions and options over options.[149]

3.39 The term "asset" is not intended to include services. The derivatives definition should not extend to contracts for the future provision of services.

Liability element

3.40 The liability element focuses on the financial risk that at least one of the parties assumes by entering into a derivatives contract. This potential financial obligation and the possibility that participants may default provide the essential rationale for derivatives regulation through, for instance:

- novation clearing, or other contract protection, for on-exchange transactions[150]
- prudential controls over OTC intermediaries[151]
- risk disclosure and "know your client" requirements for OTC transactions involving retail end-users.[152]

3.41 The liability element is satisfied where at least one party could (not necessarily would) be required to provide cash or other consideration (including entry into some other obligation), excluding a fixed initial or periodic consideration, during and/or at the termination of the contract. This liability could arise from a contract being leveraged,[153] though the upper limit of liability could be capped. Consideration may take the form of cash or physical delivery of an item.

3.42 The reference to "any initial or periodic consideration that is fixed at the time the agreement is entered into" excludes from the derivatives definition transactions in securities, notwithstanding that they create a financial risk to the counterparties during the period before their settlement.

3.43 The reference to consideration includes entry into some other obligation, for instance, an option over a futures contract.

Forward contracts and physical delivery

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149 AFMA *On-exchange Submission* and BT *On-exchange Submission* emphasised that the derived value element should cover derivatives deriving their value from other derivatives.

150 Recommendation 12.

151 Recommendations 26 and 27.

152 Recommendations 29 and 31.

153 A derivatives transaction is leveraged where the initial consideration for entering into the transaction is considerably less than the face value of the subject matter of the agreement. This allows a party to maintain a derivatives transaction without necessarily having to pay its full face value. However, depending on any variations in the value of the subject matter, a party may incur an additional liability.

3.44 A forward contract involves an obligation on one party to buy, and the other to sell, an underlying asset at a specific price and date in the future. The Advisory Committee, in its OTC Discussion Paper, proposed that the derivatives definition exclude forward contracts which in practice result in physical delivery. Some submissions supported this exclusion.[154] Other submissions argued that the proposal may exclude some commonly accepted types of derivatives, such as forward rate agreements which could involve physical delivery.[155]

3.45 The Advisory Committee notes that the futures contract definition in the Corporations Law was intended to cover cash-settled and deliverable transactions. However, it sought to exclude ordinary commercial forward agreements which were subject to deferred physical delivery. That exclusion, as it currently operates, has a number of complex and imprecise elements.[156]

3.46 The Advisory Committee considers that a physical delivery exclusion of a different type is necessary to ensure that the derivatives definition does not include ordinary commercial forward agreements. Only those contracts under which physical delivery of a commodity, other than a currency, is *mandatory* should be excluded from the derivatives definition. Physical delivery would not be mandatory if the possibility of close-out existed. The Committee recognises that a vendor who does not own the property the subject of a mandatory physical delivery forward transaction has the same exposure and therefore creates the same counterparty credit risk as if the arrangement were to be cash-settled. However, without this physical delivery exclusion, the derivatives definition would unnecessarily regulate ordinary commercial forward agreements.

Hedging or speculation

3.47 The Advisory Committee does not consider that the derivatives definition should distinguish between hedging and speculative derivatives transactions (though this distinction might still be necessary for other purposes[157]). A transaction might be speculative for one party and a hedge for the counterparty. It would be impractical to

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154 SFE *OTC Submission*, AARF *OTC Submission*.

155 AFMA *OTC Submission*, Westpac *OTC Submission*, RBA *OTC Submission*.

156 The definition of "adjustment agreement" covers only non-deliverable contracts, settled by payment of differences. The definition of "eligible commodity agreement" is intended to cover deliverable contracts. It requires that the contract contain a legal, rather than merely an economic, obligation to make or accept delivery of the commodity (*Carragreen Currency Corporation Pty Ltd v CAC (NSW)* (1986) 11 ACLR 298, *SFE v ASX* (1995) 16 ACSR 148). Yet delivery must be unlikely. In deciding whether discharge other than by physical delivery is likely, it is necessary to have regard to all the circumstances, including the terms of the agreement, market practices and how agreements of this kind are generally settled. See further *CASAC Research Paper* at 11-12, 23-24. It may be difficult to apply this test to those agreements for which there is no general practice regarding their settlement either by cash adjustment or physical delivery, for instance deliverable share futures contracts. Given this, regulations have been enacted under s 72A to facilitate the trading of deliverable share futures and deliverable bond futures on the SFE.

157 For instance, the Financial Institutions Code 1992 s 120 restricts building societies and credit unions to transacting in derivatives to reduce the risk of adverse movements in the costs of borrowing or raising funds or the revenue obtainable from investments or financial accommodation provided.

regulate only one side of a transaction or base a definition on the subjective intention, or state of affairs, of either or both parties.

Separating transactions

3.48 The definition should be applied on a transaction by transaction basis, even where transactions are entered into under a master agreement that provides that all transactions under it form a single agreement.[158]

Application of definition to current products

3.49 The derivatives definition is intended to apply to all futures contracts and existing derivative securities, including LEPOs, warrants and other options (excluding those issued by a company permitting the taker to subscribe for the company's unissued shares) and share ratios. It is also intended to cover all derivatives transacted on the Australian OTC market.[159] There would be no equivalent of the s 72(1)(d) definitional exceptions.

Options

3.50 An option contract is one that gives the buyer the right, but not the obligation, to either buy or sell an underlying asset by a certain date for a certain price. For this right, the buyer pays the seller a "premium".

3.51 Under the current law, it is difficult to determine the appropriate classification of options.[160] However, options would come within the proposed derivatives definition. They would satisfy the *derived value element*, as they derive their value from the underlying subject matter, whether it be an asset, rate, index or other underlying. They would also satisfy the *liability element*. In some types of options, both parties may be subject to possible liability.[161] For all options, the writer of the option can be required on exercise of the option to deliver or take delivery of the subject matter of the option, or provide a cash adjustment (for instance, with options over an index).[162] In the case of futures options, the writer's obligation is to enter into the futures contract if the option is validly exercised by the taker.

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158 The ISDA Master Agreement cl 1(c) provides that "all transactions are entered into in reliance on the fact that this Master Agreement and all Confirmations form a single agreement between the parties ... ".

159 These include swaps, interest rate options, forward rate agreements, foreign exchange transactions, currency and bond options, synthetic agreements for forward exchange and reciprocal purchase agreements. For details refer to the *AFMA Guide to the AFMA/ISDA Documentation*.

160 CASAC Research Paper at 23-26.

161 For instance, the takers as well as the writers of LEPOs can be subject to margin requirements.

162 **Summary of rights and obligations if options are exercised**

	Writer (Option Seller)	Taker (Option Buyer)
Put	obligation to buy (take delivery) or pay cash	choice to sell (deliver) or receive cash

3.52 Notwithstanding that options would fall within the proposed deductive definition of derivatives, the Advisory Committee considers that it would be over-regulatory for all options to be regulated as derivatives. For instance, options to purchase land or consumer goods do not require the protection of derivatives regulation. The Advisory Committee considers that the only options that should be classified as derivatives are:

- options over derivatives
- options over securities[163] (other than an option issued by a company permitting the taker to subscribe for the company's unissued shares, which are capital raising agreements and should be classified as a security[164])
- options that are traded on a financial exchange
- any other category of option prescribed by regulation, which could cover commodity options that are being used as risk management tools or otherwise in a similar way to other derivatives.

3.53 The OTC DP raised the issue whether fully paid bought options should be excluded from the derivatives definition. Under fully paid bought options, the full premium is paid at the outset by the purchaser who will have no further potential liability. The purchaser's only risk in these options is losing the premium. This contrasts with options where only part of the premium is paid initially and the purchaser has a contingent liability for the unpaid amount.

3.54 Most submissions opposed exempting the purchaser of these fully paid options.[165] This would result in different rules applying to the seller and purchaser of options and to bought and sold options. The Advisory Committee agrees that there should be no exemption for these options.

Call	obligation to sell (deliver) or pay cash	choice to buy (take delivery) or receive cash

163 This approach would be consistent with the inherent distinction between derivatives and securities. M Starr, Policy Director, Government and Legislative Affairs, SFE, in his Paper, *Introduction to Derivatives* (NSW Young Lawyers Accounting and Derivatives Seminar 30 May 1996) said that "share options resemble futures contracts more than they do shares. Neither share futures nor share options represent an ownership interest in the share or the ongoing benefits enjoyed by a shareholder. Both futures and stock options involve commitments to further actions. Neither involve even the extension of a down payment or credit extension other than the performance bond nature of an initial margin. Any divergence in regulatory policy between futures and share options is attributable more to timing of the introduction of these instruments, the regulatory attitudes at the time, and stock market influence rather than a conscious public protection policy decision."

164 The classification of these instruments as securities rather than derivatives was supported in submissions, for instance, SFE *On-exchange Submission*, AARF *On-exchange Submission*, RBA *On-exchange Submission*.

165 ASC *OTC Submission*, Treasury (formerly Attorney-General's Department) *OTC Submission*, RBA *OTC Submission*, ABA *OTC Submission*, AFMA *OTC Submission*, ANZ Banking Group *OTC Submission*, ASCT *OTC Submission*, AARF *OTC Submission*, IBSA *OTC Submission*, ISDA *OTC Submission*, Phillips Fox *OTC Submission*, SFE *OTC Submission*, Westpac *OTC Submission*.

Exemptions

3.55 Throughout its derivatives review, the Advisory Committee has been aware that the definition of derivatives should not be too wide, lest it inappropriately regulate other financial instruments.

3.56 In its OTC DP, the Advisory Committee proposed that contracts exempted by the ASC be excluded from the derivatives definition. Some respondents to the OTC DP expressed concern about leaving the exemption criteria to the discretion of the ASC, and the possibility of substantial uncertainty concerning the legal status of innovative products.[166]

3.57 Taking these concerns into account, the Advisory Committee subsequently sought to develop a definition that would not give the ASC a major role in determining what instruments constitute derivatives. In its On-exchange Draft Report, the Advisory Committee proposed that:

- an agreement would not be a derivative if it would not be regarded as a financial agreement by the commercial community
- any statement by the ASC that an agreement is not so regarded should be taken as prima facie evidence of that fact.

3.58 The Committee regarded this approach as having the following advantages:

- it would facilitate product innovation by permitting those developing new products to assess for themselves whether a product was a derivative, without any obligation to seek an ASC exemption
- if product developers wanted further assurance, they could approach the ASC for a view on whether a new product was a derivative, this view to be prima facie evidence of the proper classification of the product.

3.59 However, some respondents to the On-exchange Draft Report criticised this approach, arguing that:

- the term "commercial community" does not have a sufficiently commonly understood meaning to enable product developers to know to whose views they should have regard in determining whether a product was a derivative
- even if it were possible to determine who constituted the commercial community, it may be impossible to determine how that group would regard a new product before it had become public
- it would be unrealistic to expect product originators to canvas widely the nature of an innovative product in advance of its market launch
- the proposal could give the ASC too great a discretion to determine what constituted a derivative.[167]

166 ISDA *OTC Submission*, AFMA *OTC Submission*.

167 For instance, AFMA *On-exchange Submission*, ASX *On-exchange Submission*, SFE *On-exchange Submission*, BT *On-exchange Submission*, ANZ *On-exchange Submission*.

3.60 In view of these criticisms, the Advisory Committee has concluded that the only feasible method of excluding inappropriately regulated products from the derivatives definition is by regulation or by specific exemption of classes of agreements.

3.61 There should be provision for the Corporations Regulations to exclude from the derivatives definition particular classes of agreements, for instance:

- agreements under which physical delivery of a commodity other than a currency is mandatory
- agreements where the consideration can be varied only by reference to an inflation index (such as the Consumer Price Index)[168]
- at-call or term deposits with banks or other financial institutions[169]
- all insurance contracts regulated by the ISC
- chattel and real property mortgages.

3.62 The insurance contract exemption applies only to contracts regulated by the ISC. This exemption from the derivatives definition would not apply to other derivatives transactions, such as credit default swaps,[170] which could be characterised as a form of insurance contract.

3.63 In addition, there should be a power to declare any other class of agreements not to be derivatives. The Advisory Committee notes the Financial System Inquiry Recommendation that the Commission, rather than the Minister, have a power of this nature.[171]

Consequential amendments

3.64 Various revenue, superannuation and other statutes that rely on the Corporations Law definition of futures contract may need to be reviewed to determine whether they should apply equally to derivatives. Also, some procedures under Chapter 7 of the Corporations Law, particularly those relating to the transfer and settlement of

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168 The purpose of the inflation-based exemption is to exclude from the derivatives definition forward contracts where the otherwise fixed consideration to be paid over time can be altered according to the level of inflation during the contract period (for instance, simple uplift clauses in rental agreements).

169 Deposits may otherwise be derivatives if, for instance, the interest rate payable on the deposit may be based on the prevailing market rate. This exemption should not include derivatives associated with the deposit or lending activities of banks. Usually, the transaction between a bank and its customer (for instance, a fixed rate loan or deposit) is not a derivative. Instead, the bank enters into a derivative with a third party to offset the risk of that transaction.

170 Under a simple credit default swap, one party (X) pays a fee or premium to the counterparty (Y) (either initially or periodically) in return for a right to a contingent payment from Y, related to the creditworthiness of Z, a borrower from X. X will be entitled to a contingent payment from Y if Z defaults in respect of a stated credit default event, such as Z's insolvency or credit downgrading.

171 *Financial System Inquiry Final Report* Recommendation 19.

securities, should apply to derivatives over securities if and when they are settled by physical delivery.[172]

Problems of recharacterisation

3.65 Various private arrangements, such as trust deeds and portfolio management agreements, contain provisions prohibiting or limiting transactions in "futures contracts". These provisions may need to be reviewed to determine whether all or some of these prudential safety requirements should apply to all derivatives or only particular classes of them. It may be appropriate to provide a transition period after enactment of any derivatives legislation to permit adjustment of these deeds and agreements.

Definition of derivatives

Recommendation 4. A derivative should be defined in the Corporations Law as any agreement:

- the value of which is ultimately derived from, or varies according to, the value of one or more assets, rates, indices or other underlying (*derived value element*), and
- whereby one or both parties, at some future time, may have to provide cash or other consideration (excluding any initial or periodic consideration that is fixed at the time the agreement is entered into) to the counterparty or a substitute counterparty (such as the clearing house), that consideration ultimately being determined in whole or part by reference to the derived value element (*liability element*).

Only the following options should be classified as derivatives:

- options over derivatives
- options over securities (other than options issued by a company permitting the taker to subscribe for the company's unissued shares, which should be classified as securities)
- exchange-traded options
- any other category of option prescribed by regulation (this could cover commodity options that are being used as risk management tools or otherwise in a similar way to other derivatives).

The Corporations Regulations could set out specific classes of agreements that are not to be regarded as derivatives, for instance:

- agreements under which physical delivery of a commodity other than a currency is mandatory

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172 See, for instance, Corp Reg 1.2.23(1) which applies Part 7.2A (settlement and clearing of transactions) and Part 7.13 (transfer of securities) of the Corporations Law to deliverable share futures contracts traded on the SFE. These contracts are based on CHESS-eligible shares.

- agreements where the consideration can be varied only by reference to an inflation index (such as the Consumer Price Index)
- at-call or term deposits with banks or other financial institutions
- all insurance contracts regulated by the ISC
- chattel and real property mortgages.

In addition, there should be a power to declare any other class of agreements not to be derivatives.

Definition of securities

On-exchange and OTC

3.66 The current definition of "securities", for the purposes of regulation under Chapter 7 of the Corporations Law, is intended to cover capital raising instruments used by companies, collective investment schemes and government entities, namely shares, debentures,[173] prescribed interests and bonds. Securities such as shares also confer proprietary rights[174] and may generate other forms of entitlement to the assets of companies (for instance, dividend rights). The primary function of the securities market is to facilitate the transfer of these rights. By contrast, the proposed definition of derivatives focuses on financial risk management rather than fundraising arrangements. The primary function of the derivatives market is to provide opportunities for participants to tailor and transfer these risks.

3.67 The Advisory Committee proposes that the current s 92 definition of securities, in the context of financial markets regulation only,[175] be amended to exclude all option contracts, other than options issued by a company permitting the taker to subscribe for the company's unissued shares. These options are essentially capital raising instruments. All other options over shares or share indices, including warrants, would be derivatives.[176]

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173 For instance, Qanmacs would be securities, not derivatives. They satisfy the derived value element of the derivatives definition, as their value throughout is ultimately derived from the value of the underlying Qantas shares. However, they would not satisfy the liability element of that definition. The cash that the issuer of the Qanmac must pay depends on the value of the dividends payable on Qantas shares rather than on the value of the Qantas shares. These dividends can affect the market value of Qantas shares, but the dividends are not dependent either in whole or in part on the market value of the Qantas shares. Qanmacs will be securities, as they are debentures. It is appropriate that Qanmacs be securities (debentures) rather than derivatives as they mirror the performance of Qantas shares in relation to both their ongoing value (that is, the secondary market in Qanmacs reflects the secondary market in Qantas shares) and the dividend returns (the returns on Qanmacs reflect the returns of Qantas shares).

174 *Gambotto v WCP Limited* (1995) 16 ACSR 1 at 11.

175 The existing definition of securities should remain for all other purposes, including share acquisitions under Chapter 6 of the Corporations Law, share buy-backs, reductions of capital and schemes of arrangement.

176 A company that acquires an option to purchase its own shares would be acquiring a derivative, not a security. However, if and when it sought to exercise that option, it would acquire a security, thereby attracting the rules regulating share buy-backs and capital reductions.

3.68 Classifying warrants as derivatives, rather than securities, would not require any change to the current prospectus-type disclosure requirements for these products. Currently, the ASX requires warrant issuers to provide Offering Circulars containing such disclosures.[177] However, the ASC currently provides prospectus exemptions for these warrants.[178] Any other exchange on which warrants are traded could impose a similar requirement, and other admission and ongoing disclosure and other controls on warrants, through its business rules.[179]

Definition of securities

Recommendation 5. A security, in the context of financial markets regulation, should be defined as:

- a share in, or debenture of, a body corporate
- a debenture, stock or bond issued or proposed to be issued by a government entity
- a prescribed interest (collective investment scheme interest)
- a unit of a share or prescribed interest
- an option issued by a company permitting the taker to subscribe for the company's unissued shares.

Interaction of the derivatives and securities definitions

On-exchange and OTC

3.69 Ideally, the derivatives and securities definitions should be mutually exclusive.[180] The effect of the Advisory Committee's approach is that all current classes of transactions on the ASX that fall within the proposed derivatives definition would be derivatives only, not securities.[181] Also, the Advisory Committee has recommended that the Corporations Regulations exempt particular types of arrangements from being derivatives.[182] Nevertheless, some hybrid arrangements may still satisfy both definitions.[183] The Advisory Committee has considered whether in

177 ASX r 8.7 prescribes the content of Offering Circulars. Rule 8.7.5 reflects the prospectus obligations in s 1022. One purpose of the Offering Circular is to assist purchasers in assessing the counterparty credit risk of the warrant issuer, given that the final settlement of the warrant is effected off-market without the protection of the NGF.

178 ASC Policy Statement 56.94-96.

179 See generally ASX Business Rules Section 8.

180 A number of submissions emphasised the importance of clarifying the relationship between the derivatives and securities definitions: AFMA *OTC Submission*, Treasury (formerly Attorney-General's Department) *OTC Submission*, BZW *OTC Submission*.

181 The relevant ASX transactions are LEPOs, share options, share index options, share ratio contracts and warrants. The exclusion from the proposed securities definition (and inclusion in the derivatives definition) of all options over shares (other than options issued by a company permitting the taker to subscribe for the company's unissued shares) and share indices would mean that share index options, LEPOs, warrants and other share options are derivatives, not securities. In the absence of s 92A (which the Advisory Committee proposes be repealed), share ratio contracts would be derivatives, not securities.

182 Recommendation 4.

183 For instance, bonds whose return is linked to the performance of a key index.

these circumstances one definition should prevail. Currently, the definition of futures contract is generally taken to be dominant.[184]

3.70 There are several possible policy options:

Policy Option 1: double regulation, that is, provide that transactions which are covered by the securities and derivatives definitions are to be regulated as both, subject to ASC relief.[185] This would overcome attempts to avoid either derivatives or securities regulation. However, this option might create considerable regulatory duplication and the possibility of overlap between derivatives and securities fidelity funds.[186] Some respondents were concerned about the ASC's discretionary power to determine the classification of products, and the criteria for consultation or review.[187]

Policy Option 2: self-choice, that is, issuers should have the option to determine whether products which come within both definitions are derivatives or securities. The Advisory Committee opposes this self-choice approach. It could lead to considerable market confusion and inconsistent regulation of arrangements that are economically and functionally similar.

Policy Option 3: derivatives definition predominant, that is, exclude all derivatives from the definition of securities. This runs the possible danger of fundraising arrangements being designed as derivatives to avoid the prospectus requirements

Policy Option 4: securities definition predominant, that is, exclude all securities from the definition of derivatives. This runs the possible danger of risk management instruments being designed as debentures[188] or other securities

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184 Section 92 provides that futures contracts are excluded from the definition of securities. However, Gummow J of the Full Federal Court in *SFE v ASX* (1995) 16 ACSR 148 at 178 suggested that some arrangements could be both futures contracts and securities, in which case "both, not one, regulatory regime would apply according to the terms of each of them [since] it is the identity of the market which brings about classification under Chapter 7 (securities) or Chapter 8 (futures)".

185 The Advisory Committee would see the role of the ASC under this Policy Option as determining the substantial nature and purpose of the agreement, not merely its legal form. For instance, is the purpose of an agreement which satisfies the tests of derivative and debenture in essence risk management or fundraising? An example would be a debenture where the amount of interest paid at a particular time is linked to the level of some index at that time. This debenture would be a derivative as well as a security, as it satisfies the derived value and liability elements of that definition. It could be designated by the ASC as a security only, notwithstanding these derivative elements, as it is essentially a fundraising arrangement. In other circumstances, the ASC, before designating the transaction as a security, might consider whether the transaction leads to the transfer of property rights in shares or other indicia of ownership.

186 SEGC *On-exchange Submission*.

187 BT *On-exchange Submission*, AIMA *On-exchange Submission*.

188 The Corporations Law s 9 defines a debenture as "a document issued by the body that evidences or acknowledges indebtedness of the body in respect of money that is or may be deposited with or lent to the body ...". An issuer might seek to attract this provision by incorporating an acknowledgement of indebtedness for a nominal amount to be lent to the issuer into what is otherwise a derivatives contract.

to avoid derivatives regulation. However, these instruments would be subject to the prospectus requirements.

3.71 The Advisory Committee supports Policy Option 4. It would be unlikely that persons would seek to artificially structure products as securities, given the considerable disclosure and related due diligence obligations under the prospectus provisions.

3.72 However, the Advisory Committee notes the possibility that a person may structure a transaction as a securities rather than a derivatives transaction merely to take advantage of the exclusions from the prospectus provisions, for instance offers of at least $500,000 or offers to 20 or fewer people in a 12 month period.[189] A possible solution would be to provide that a financial instrument that could satisfy both the derivatives and the securities definitions should be classified as a security, unless the instrument would fall within one of the exemptions from prospectus regulation in which case it would be classified as a derivative. However, the Committee does not favour this approach, as an instrument might be regulated differently depending on how it was marketed. Instead, the Committee recommends that this area should be kept under review and that Policy Option 1 (subjecting products that fall within both definitions as securities and derivatives to both forms of regulation, subject to ASC relief) could be adopted if it appears that transactions are being structured merely to take advantage of the prospectus exemptions.

Interaction of the derivatives and securities definitions

Recommendation 6. All securities should be excluded from the definition of derivatives. However, if, in the future, products are artificially structured as securities to avoid disclosure requirements, the Government should consider regulating products that could be either derivatives or securities as both, subject to the ASC exempting the products from one or other form of regulation.

189 s 66.

Chapter 4: Derivatives market regulation

This Chapter deals with the proposed regulatory requirements for authorisation as a financial exchange to conduct a market in derivatives, or authorisation to conduct an OTC market in derivatives.

Authorising derivatives markets

Process of authorisation

4.1 Currently, a person may not establish or conduct, in Australia, a stock market or a futures market unless that market is authorised.[190] The Advisory Committee takes the view that, within a more generic concept of financial markets, a distinction must still be maintained between derivatives and securities markets.[191] A person should be prohibited from conducting a derivatives market unless authorised.[192] Currently, the Minister must authorise a market. However, the Financial System Inquiry proposed that the Commission rather than the Minister should have general responsibility for approving on-exchange and OTC markets.[193]

Definition of derivatives market

4.2 A "derivatives market"[194] could be defined as:

> "any market, exchange or other place at which, or a facility[195] by means of which, in Australia:[196]
>
> - derivatives contracts are regularly[197] acquired or disposed of[198]
> - offers to enter into derivatives contracts are regularly made or accepted, or
> - information is regularly provided about the prices at which, or the consideration for which, particular persons, or particular classes of persons,

190 ss 767, 1123.

191 paras 3.15 ff, supra.

192 SFE *OTC Submission*.

193 *Financial System Inquiry Final Report* Recommendations 2, 23.

194 cf s 9 "stock market", "futures market".

195 ASC Policy Statement 100 para 15 states that the term "facility" broadens the scope of a market beyond a geographical place to include, for instance, screen-based trading systems. The concept of "facility" was given this wide interpretation in *Carragreen Currency v CAC* (1986) 11 ACLR 298 at 312-313.

196 Compare ASC Policy Statement 100 para 12 which states: "A facility is conducted in Australia if offers or invitations are regularly made in Australia, acceptances regularly take place in Australia or information is regularly provided in Australia. An offer or invitation is made in Australia if it is received in Australia".

197 Compare ASC Policy Statement 100 para 14 which states: "In the ASC's view, “regularly” in the definition does not mean at specified intervals. Rather, it means systematically, in the sense that there are recurring opportunities to buy, sell or exchange securities". The requirement of regularity would prevent single bilateral transactions from constituting a derivatives market.

198 cf ss 23, 24.

propose, or may reasonably be expected, to acquire or dispose of derivatives contracts, whether or not transactions are made on or through that facility".

4.3 The Advisory Committee considers that a broad derivatives markets definition is necessary to cover innovative derivatives markets structures and arrangements that may emerge. However, a wide definition could, for instance:

- include persons who are simply frequent end-users
- apply to treasury operations within a corporate group[199]
- apply to cross-trading between collective investment funds having the same fund manager[200]
- cover activities which also attract the licensing requirements (thereby blurring the distinction between market and licensing regulation), and
- apply to the Internet if it provides a means of entering into privately negotiated bilateral derivatives transactions.

4.4 To deal with these concerns, the Advisory Committee considers that derivatives activities should be regulated as a derivatives market only if the public interest is served by doing so. To achieve this, the Committee proposes that the following phrase be added at the end of the proposed definition of "derivatives market":

> "and where the ASC, in the public interest, designates the activity as a derivatives market".

4.5 The legislation or the Explanatory Memorandum could provide criteria for determining the public interest. The Advisory Committee considers that the overriding public interest is to ensure the integrity of any derivatives market. The ASC could issue a Policy Statement elaborating on that concept. For instance, in the context of stock markets, the ASC considers that market integrity includes fair treatment of users, reliable price formation and markets being free of misleading, manipulative or abusive conduct.[201] In practice, persons who wish to conduct a derivatives market may well take the initiative to apply for authorisation, without waiting for the ASC to designate their activities as a derivatives market.

4.6 The ASC's proposed role, in effect to limit the width of the derivatives market definition, would:

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199 AFMA *OTC Submission*, ASCT *OTC Submission* and Phillips Fox *OTC Submission* pointed out that internal corporate treasury functions may technically involve operating a facility for the purpose of the definition of "derivatives market".

200 AIMA *OTC Submission*, IFA *OTC Submission*, NMFM *OTC Submission* pointed out that cross-trading in OTC derivatives transactions between funds having the same fund manager could technically amount to making a market by bringing together buyers and sellers.

201 ASC Policy Statement 100 para 18. In relation to whether OTC derivatives information bulletin boards, information vendors and low volume markets should be regulated as derivatives markets, similar considerations could apply as for stock markets: id at paras 98-106, 126-129, 139-141. For possible conditions that could be attached to derivatives bulletin boards, regulated as derivatives markets, compare ASC Policy Statement 100 para 109.

- provide a mechanism to avoid the over-regulatory consequences mentioned above
- avoid the need for all affected parties to seek an exemption from being a derivatives market, as under the current futures market approach[202]
- reduce regulatory costs by avoiding the ASC having to process exemptions.

4.7 In considering whether to designate an activity as a derivatives market, the ASC should take into account whether the activity might be more appropriately dealt with under the licensing provisions. No person should be subject to both derivatives market regulation and derivatives licensing for the same activity.

Application to conduct an on-exchange or OTC derivatives market

4.8 The Advisory Committee has considered whether there should be any circumstances in which an applicant should be restricted to applying for an exchange, rather than an OTC, market authorisation, that is, a form of "on-exchange rule".

Current on-exchange requirement

4.9 Currently, there are restrictions on persons conducting a market in futures contracts except as an exchange. All futures contracts must be exchange-traded (or traded pursuant to exchange business rules[203]), unless they fall outside the Corporations Law definition of futures contract[204] or are transacted on an exempt futures market or a recognised overseas exchange.[205] This "on-exchange" rule, and the related requirement that all futures brokers must be members of futures organisations, were introduced in response to "bucketing"[206] and other manipulative off-exchange practices directed mainly at retail participants before enactment of futures regulation in 1986. There was also a concern that, without an on-exchange rule, persons could set up facilities to compete with exchange markets by offering similar derivatives products, but without any equivalent of the co-regulatory structure that applies to exchanges and covers conduct of business rules, supervised clearing arrangements, fidelity funds and dispute resolution procedures.[207]

4.10 The current on-exchange rule has caused some difficulties in practice. The Australian OTC derivatives market involves increasingly standardised products or documentation.[208] However, standardisation is a key element of the definition of "futures contract". In consequence, various OTC products may require specific

202 s 1127.

203 Currently, exchange for physicals (EFPs) are transacted off-exchange but pursuant to the SFE business rules: SFE General By-law G.7.

204 s 72(1)(d).

205 ss 1258, 1127.

206 Bucketing is the failure of a broker to comply with a client's instructions to execute trades on-exchange.

207 ss 1126, 1131, 1132.

208 The extensive use of International Swaps and Derivatives Association (ISDA), and to a lesser extent, Australian Dollar Interest Rate Terms (AIRS) and Australian Bankers Association Forward Rate Agreements (ABAFRA), terms for off-exchange derivatives transactions increases the likelihood that they are standardised.

statutory[209] or Ministerial[210] exemptions from the general Corporations Law obligation on brokers to trade their clients' standardised futures products only on-exchange.

4.11 The Advisory Committee recognises that the current "on-exchange rule" could not reasonably be applied to all derivatives, given that the proposed derivatives definition seeks to cover all OTC as well as on-exchange derivatives. Instead, the question is whether any on-exchange restriction should apply to derivatives markets and, if so, what form it should take.

The disincentive problem

4.12 Currently, the exchange market is subject to detailed co-regulatory requirements that have no equivalent in the OTC market.[211] This creates the possibility that applicants may prefer to be authorised to conduct an OTC market, even for products traditionally exchange-traded, to avoid the greater regulatory requirements, and consequent cost disadvantage, in being a financial exchange authorised to conduct a market in derivatives (the disincentive problem). The Financial System Inquiry has noted that technological developments now make it possible for an individual financial market participant to offer centralised trading platforms competing directly with exchanges.[212] This issue has also arisen in other jurisdictions.[213]

4.13 The Advisory Committee considers that the exchange mechanism, which provides for public price discovery and contract protection,[214] performs a key economic role and should be preserved for the benefit of market participants. The Committee also sees considerable merit in the current co-regulatory arrangements that ensure that exchange markets perform properly and in a manner that justifies public confidence in their operation. The Committee does not consider that the possible disincentive problem should be overcome by materially reducing the nature or content of the co-regulatory structure for exchanges.

4.14 The Advisory Committee notes the view of the Financial System Inquiry that the regulation of exchanges should not be excessive compared with the OTC market.[215] This can be dealt with by permitting exchanges the maximum degree of self-regulation and discontinuing obligations that are unduly burdensome without any corresponding regulatory benefits, in particular the obligation in all instances on futures brokers to provide risk disclosure statements to their wholesale clients.

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209 s 72(1)(d).

210 s 1127; ASC Policy Statement 70.

211 Parts 8.2 and 8.6 set out the requirements for futures exchanges, clearing houses, futures associations and fidelity funds.

212 *Financial System Inquiry Final Report* at 281.

213 For instance, Alan Greenspan, Chairman, Board of Governors of the US Federal Reserve System in a Paper to a Financial Markets Conference (21 February 1997) stated that US futures exchanges argue that their regulatory burden makes it impossible for them to compete with off-exchange markets.

214 Recommendation 12.

215 *Financial System Inquiry Final Report* Recommendation 22.

4.15 The Committee has considered the alternative approach of increasing the regulation of OTC markets to a level comparable to exchange markets. The Advisory Committee does not support this approach. This would involve developing a detailed co-regulatory structure which may be unnecessary to ensure a fair and orderly OTC market. The purpose of this approach would be merely to achieve regulatory parity with the exchange market. Also, the regulatory requirements that support exchange contract protection would not be relevant to an OTC market that functions without this protection. Instead, the Advisory Committee agrees with the Financial System Inquiry that formal exchanges should continue to be subject to more detailed regulatory requirements than OTC markets, in part because they operate a centralised market open to a large number of participants.[216]

4.16 In summary, the Advisory Committee does not see that the disincentive problem can be solved by either materially decreasing the regulatory requirements for financial exchanges authorised to conduct a market in derivatives or by materially increasing the regulatory burden on OTC derivatives markets.

Regulatory options to deal with the disincentive problem

4.17 The Advisory Committee has considered the following four policy options in response to the disincentive problem. An applicant should only be authorised to conduct an exchange, rather than an OTC market, where that applicant:

Policy option 1:	proposes to provide a contract guarantee, or other contract protection arrangement
Policy option 2:	proposes a self-regulatory structure
Policy option 3:	proposes to operate a market involving any fungible[217] derivatives transactions, or
Policy option 4:	proposes to operate a market that involves fungible derivatives transactions and from which retail end-users are not excluded.

4.18 *Policy option 1.* The Advisory Committee does not support this policy option. It would create a disincentive for applicants who wish to conduct an OTC market from implementing any contract protection arrangements. Some contract protection

216 *Financial System Inquiry Final Report* at 282.

217 A fungible agreement would be any standardised agreement that is fully interchangeable with a substitute transaction of the same class. The Group of 30 Report *Derivatives: Practices and Principles* (July 1993) at 32 stated that "full standardisation leads to fungibility - that is, contracts of the same maturity are perfect substitutes. These characteristics are designed to facilitate anonymous trading in an active and liquid exchange market." The concept of fungibility was also recognised in *SCF Finance Co Ltd v Masri* [1986] 2 Lloyd's Law Reports 366 at 369, where Slade LJ stated that "interchangeability ... allows buyers and sellers to offset or liquidate any of their open positions with an equal and opposite transaction". The concept of fungibility is also reflected in para (a) of the definitions of "close out" and "liquidating trade" in s 9 of the Corporations Law. The fungibility element permits on-exchange futures contracts to be closed out by entering into opposite contracts and the clearing house matching the positions. This crystallises the profit or loss inherent in the original contracts. The same close-out method is used for all options (other than warrants) and share ratio contracts traded on the ASX: see ASX r 10.8 and definitions of "Open Contract", "Market Contract" (in relation to a Ratio Contract) and "Market Contract" (in relation to an Option) in Section 12 of the ASX Rules.

arrangements (such as counterparty credit controls[218]) may be suitable for a particular OTC market if the operator of that market chooses to provide them. In other cases, a contract protection mechanism such as a settlement system may be necessary in order to conduct a fair and orderly market.[219]

4.19 *Policy option 2.* The Advisory Committee considers that this policy option may discourage applicants for OTC market authorisation from proposing or developing their own self-regulatory structures, lest they be required to apply for authorisation as a financial exchange.

4.20 *Policy option 3.* This policy option (an "on-exchange requirement" for all fungible derivatives transactions) more closely reflects current market practice. Respondents to the On-exchange Draft Report saw the essential distinction, in practice, between exchange-traded and OTC derivatives as being fungibility.[220] It is the element of interchangeability in fungible transactions that enables anonymous trading and permits exchange clearing houses to provide contract protection through novation clearing, which can involve close-out. An equivalent close-out procedure is not necessarily available for non-fungible transactions.

4.21 Any rule requiring fungible derivatives transactions to be exchange-traded is not intended to interfere with the current OTC market. There is an increasing level of standardisation in the OTC market. Standardisation is a prerequisite to, but does not suffice for, fungibility. OTC derivatives transactions that employ ISDA/AFMA Master Agreements are not thereby fungible.[221]

4.22 Some respondents were nevertheless concerned about a requirement that all fungible derivatives transactions be exchange-traded.[222] They pointed, for instance, to:

- the difficulty of accurately and precisely distinguishing in some instances between fungible and non-fungible transactions, and
- the incentive to artificially structure transactions as non-fungible to avoid any exchange requirement.

4.23 *Policy option 4.* This policy option would impose an on-exchange rule only where retail end-users have the opportunity to trade in fungible derivatives on that market. This would ensure that retail participants have the full protection of a co-regulatory exchange structure (this being one of the fundamental rationales for the

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218 para 4.79, post.

219 paras 4.31 and 4.125, post.

220 RBA *On-exchange Submission*, Michael Hains *On-exchange Submission*, SFE *On-exchange Submission*.

221 The Minter Ellison *On-exchange Submission* distinguished between the contractual and underlying economic terms of OTC transactions. The AFMA/ISDA Master Agreement provides that a series of derivatives transactions are subject to the same contractual terms. However, this does not mean that these transactions are fungible. Their economic terms, as set out in the Confirmations, provide for several fundamental economic variables. In consequence, the AFMA/ISDA Master Agreements confer on contracting parties the ability, even in respect of simple derivatives, to customise the economic terms of each underlying derivatives transaction.

222 For instance, BT *On-exchange Submission*, CSR *On-exchange Submission*, Merrill Lynch *On-exchange Submission*, The Partnership Group *On-exchange Submission*.

current on-exchange rule) when dealing in fungible derivatives transactions. A wholesale-only derivatives market would be exempt from this on-exchange requirement. This policy option would:

- allow greater flexibility in the conduct of wholesale-only derivatives markets
- provide wholesale parties with a greater choice of transacting on an exchange (with the benefits and consequent burdens of novation clearing and margining or some like form of contract protection) or on a lesser regulated OTC market (with the benefits, but counterparty credit risk burdens, of no equivalent novation clearing or other similar contract protection) for similar types of fungible derivatives products[223]
- reduce the perceived problem of applying a fungibility test to some derivatives transactions by making this test irrelevant for wholesale-only markets
- be consistent with current ASC policy which permits wholesale-only, non-exchange futures markets.[224]

4.24 Under the fourth policy option, applicants to conduct a wholesale-only derivatives market in fungible derivatives transactions would have the choice whether to apply for an on-exchange or OTC market authorisation. An applicant for an OTC market authorisation would have greater flexibility as to the structure and procedures of that wholesale-only derivatives market. The applicant would still need to establish that it can conduct the proposed OTC derivatives market in a fair and orderly manner.[225] In addition, the market manipulation and other improper conduct controls,[226] as well as the ASC surveillance, investigative and enforcement powers,[227] would apply to that OTC market, thereby providing necessary protections for wholesale participants.

4.25 On balance, the Advisory Committee favours the fourth policy option. It would:

- considerably reduce the regulatory burden on wholesale-only derivatives markets
- permit greater flexibility in the range of derivatives products that can be transacted on OTC markets in Australia, provided they are conducted in an orderly manner that is fair to all participants. This approach is consistent with international trends.[228]

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223 The Partnership Group *On-exchange Submission* argued that wholesale participants should be permitted to trade in standardised derivatives on a market that does not have the protection of a clearing house structure.

224 ASC Policy Statement 70.

225 paras 4.31 ff.

226 Recommendations 45 and 46.

227 Recommendation 48.

228 For instance, the US Futures Trading Practices Act (1992) granted the Commodity Futures Trading Commission (CFTC) explicit authority to exempt transactions between wholesale participants from most statutory requirements, including the exchange-trading requirement. The CFTC used this authority to exempt interest rate swaps and most other OTC derivatives contracts from the exchange-trading requirement.

4.26 To implement the fourth policy option, the ASC should be given a power to declare that certain derivatives market activity involves fungible transactions. The legislation could provide a general definition of fungibility (for instance, a fungible agreement could be defined as "any standardised agreement that is fully interchangeable with a substitute transaction of the same class"). The ASC declaration power would avoid persons attempting to artificially avoid a fungibility rule. It may also overcome the problem of capturing transactions which, given the circumstances, should not be treated as fungible, for instance, "back to back" transactions entered into by OTC market-makers which are intended to precisely offset the obligations incurred in other transactions with their clients.

4.27 The Advisory Committee recognises that the fourth policy option may not fully resolve the disincentive problem. It may encourage greater use of wholesale-only derivatives markets, given that these markets would avoid the greater regulatory requirements of on-exchange markets. Over time, there may be an increasing migration of wholesale activity from exchange to comparable OTC markets. The level of participation in on-exchange markets, and therefore their liquidity and price discovery capacity, may materially decline over time. The costs of conducting an on-exchange market may increasingly fall on retail participants, as well as those wholesale participants who choose to employ the exchange mechanism. In an extreme case, there may be little incentive to maintain an exchange derivatives market, though the probability of these markets disappearing may be very low, given their usefulness to OTC participants in offsetting OTC derivatives risks.

4.28 The Advisory Committee acknowledges that its recommendation that an on-exchange rule apply where retail end-users have the opportunity to trade in fungible derivatives on that market differs from the Financial System Inquiry recommendation that "market forces, rather than legislation, should determine whether a transaction is conducted on-exchange or in an OTC market".[229] The Advisory Committee notes that the *Financial System Inquiry Final Report* did not discuss the disincentive problem, or the possible ways of dealing with it.

On-exchange derivatives market application

4.29 An applicant for an on-exchange market authorisation should be required to satisfy the prerequisites for conducting a financial exchange.[230] In addition, financial exchanges and any clearing houses should have a specific statutory duty,[231] and

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229 *Financial System Inquiry Final Report* Recommendation 22.

230 These prerequisites are discussed at paras 4.55-4.72, post.

231 Futures exchanges and futures clearing houses have a specific duty to ensure that their markets operate in a fair and orderly manner: s 1137(1). The SFE Trading Etiquette is designed to enable trading on that exchange to be conducted in a fair and equitable manner: SFE art 11A.1. See also SFE General By-law G.7(d) which permits the SFE to impose additional requirements to ensure fair and orderly markets in relation to exchange for physicals. Furthermore, SFE General By-law G.13 permits the exchange or clearing house to investigate actions which may be detrimental to maintaining fair, orderly and proper trading on the SFE.

appropriate powers,[232] to ensure fair and orderly dealings on their markets. Respondents agreed.[233] Participants should not be left to their own due diligence to determine how satisfactorily an exchange market operates. Also, the powers of a financial exchange authorised to conduct a derivatives market should take into account the linkage between derivatives and securities markets. For instance, the business rules of that exchange should permit suspension of trading in any derivative based on a security, where trading in that security has been suspended.

4.30 There should be a prohibition on persons holding out or implying that they operate a financial exchange authorised to conduct a derivatives market unless they have been so approved.

OTC derivatives market application

4.31 An applicant for authorisation to conduct an OTC derivatives market should be required to show that it can conduct that market in a fair and orderly manner.[234] The Advisory Committee agrees with the Financial System Inquiry that general principles-based criteria of this nature, rather than detailed prescription, are more appropriate, and may be differently applied depending on, for instance, the proposed size of the OTC market, the nature of the derivatives products to be traded, the participants who may transact on that market and the technology adopted.[235] The general authorisation criteria might include, for instance:

- that any price formation process is reliable
- that any information provided on that market cannot be interfered with through, for instance, its unauthorised alteration
- that there be a satisfactory settlement service for any anonymous trading markets (if offered)[236]

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232 Futures exchanges have a power to give binding directions to a party to a futures contract who is not a member of the exchange for the purpose of performing this duty: s 1137(2). In addition, the ASC can give directions to futures exchanges and clearing houses to ensure orderly markets: s 1138. JS Currie in *Australian Futures Regulation* (Longman Professional, 1994) refers (at 76) to a number of possible technical shortcomings of this section, which may need to be amended accordingly. The comparable provisions for stock exchanges and clearing houses under Chapter 7 of the Corporations Law are less direct. There is no exact Chapter 7 equivalent of s 1137. Section 775, which permits the ASC to prohibit trading in particular securities, has more procedural prerequisites than s 1138. For instance, under s 775, the ASC may intervene only after first requesting a stock exchange to act. Sections 1137 and 1138 apply to the ASX in relation to trading of share ratio contracts: Corp Regs 1.2.06, 1.2.10(1)(a). In practice, the ASX also exercises an equivalent commercial responsibility in the administration of the markets it conducts in other products. For instance, ASX rr 7.9.1.1, 7.9.1.6, 7.10.3.1, 9.5.16, 9.5.17, 10.4.4.3, 10.7.4.3, 10.11.1, 10.11.2, 10.14.3 permit the ASX or its clearing house to take action to maintain a fair and orderly market. See also r 2.6(3)(iv) which obliges SEATS operators to ensure the conduct of an orderly market.

233 SFE *On-exchange Submission*, ASX *On-exchange Submission*, RBA *On-exchange Submission*, AIMA *On-exchange Submission*, BT *On-exchange Submission.*

234 cf s 1137(1).

235 *Financial System Inquiry Final Report* at 281-282.

236 cf ASC Policy Statement 100 paras 30, 31, dealing with approving entities as stock markets. The ASC takes the view that in an anonymous full trading securities market where parties to contracts do not know in advance the identity of the person with whom they will contract, there

- that any other contract protection arrangements, if offered, will be reliable and operate fairly,[237] and
- that there are market mechanisms to guard against any misleading, manipulative or abusive conduct.

4.32 Also, in determining whether the proposed OTC market will be fair and orderly, consideration should be given to:

- any conduct of business rules proposed for that market
- whether the market provides a price discovery function of such a nature that those prices should be publicly available or disclosed.

4.33 Any approval could be made subject to minimum standard conditions, similar to those currently applying to exempt stock market declarations.[238]

4.34 The Advisory Committee does not consider that persons who conduct OTC derivatives markets should have powers comparable to those for financial exchanges.[239] This would require a co-regulatory OTC market structure comparable to exchange markets. Instead, the ASC should have appropriate powers to ensure the orderly conduct of each OTC market.[240] For instance, the ASC should have the power to give directions to participants in the OTC market where this was in the public interest.

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should be adequate provision for settlement services to be offered in conjunction with that market. This contrasts with an information-only market, where agreements for the sale and purchase of securities are reached by private negotiation between the buyer and the seller. Settlement services would not be required in an information-only market.

237 The *Financial System Inquiry Final Report* noted that: "Derivatives markets now offer a range of clearing mechanisms with varying degrees of counterparty risk. New approaches such as bilaterally negotiated derivatives transactions cleared through a centralised system are now technically feasible" (at 281).

238 Compare *Financial System Inquiry Final Report* Recommendation 23 and ASC Policy Statement 100 paras 79-80, in which the ASC suggested conditions designed to ensure that:
- the ASC has full access to information about the operation of the market, and is informed about breaches of conditions of its approval, suspected contraventions of the Law, or any other unlawful or undesirable conduct by any market participant or user
- appropriate records are kept of the identity of market users and, where relevant, transactions taking place on, or by means of, the market
- the market operates as described in the application for exempt market status, or as approved by the ASC
- the operator is bound to take appropriate action if it suspects that unlawful or undesirable conduct is or may be occurring in connection with the market
- the market is conducted in accordance with written rules that are binding on the market operator and all market participants.

The ASC will also require the operator of an exempt stock market annually, or more often if required, to prepare and forward to the ASC a report on compliance with the conditions of the declaration and with the rules under which the market is conducted. The ASC could also require the operator to provide the Commission with regular reports on market activity and otherwise assist the Commission if requested to do so.

239 The equivalent of s 1137(2), (3) should not apply to persons conducting an OTC derivatives market.

240 These powers should be based on s 1138.

4.35 The Advisory Committee has also considered whether applicants for approval to conduct an OTC derivatives market should make provision for fidelity fund arrangements or, alternatively whether any participants in that market should have indemnity insurance.

4.36 The Advisory Committee considers that whether any fidelity fund arrangement should be required as a condition of approval to operate an OTC derivatives market should be considered only if a self-regulatory structure, with functions and powers comparable to those of exchanges, is established to supervise that market. The Committee does not see the need, at present, for any such formal structure.

4.37 Many respondents opposed the possible alternative of compulsory indemnity insurance for any participants in an OTC derivatives market.[241] They argued that indemnity insurance, even if available, is not required in any overseas OTC market and therefore could place the Australian market at a competitive disadvantage. It would also be costly and could overlap with risk management practices.

4.38 The lack of any fidelity fund arrangement, or compulsory indemnity insurance, in an Australian OTC derivatives market could restrict the capacity of clients to obtain compensation from OTC licensees who breach their obligations. Also, the level of capital required of licensees may bear no relation to possible claims that could be made against them. The proposed generic risk disclosure statement should fully identify these risks.[242]

4.39 One submission suggested that OTC market licensees should be required to disclose upon request by the client or counterparty whether they have indemnity insurance and, if so, the scope of this cover.[243] The Advisory Committee recognises that market forces may put pressure on licensees, if asked, to disclose whether they have this insurance. However, there may be non-disclosure clauses in policies which invalidate those policies if the insurance details are disclosed. The Advisory Committee recognises the commercial sensitivity behind these non-disclosure clauses. It therefore does not support any statutory disclosure obligation. Licensees who make actual disclosures are subject to the Trade Practices Act or common law principles for any representations they may make in those disclosures.

On-exchange and OTC derivatives market applications

4.40 Any entity that has been approved to operate a financial exchange authorised to conduct a derivatives market could also apply, either itself or through a related entity, to conduct an OTC derivatives market (subject to the proposed on-exchange requirement). For instance, a financial exchange might wish to operate a wholesale-only market in fungible derivatives without the need for contract protection arrangements or other requirements comparable to those for an exchange market. In

241 ANZ *OTC Submission*, IBSA *OTC Submission*, ISDA *OTC Submission*, Merrill Lynch *OTC Submission*, Phillips Fox *OTC Submission*, Westpac *OTC Submission*, Treasury (formerly Attorney-General's Department) *OTC Submission*, AFMA *OTC Submission*, John O'Sullivan *OTC Submission*, SFE *OTC Submission*, JP Morgan *OTC Submission*.

242 para 7.34, post.

243 ASC *OTC Submission*.

these cases, the applicant would have to establish that its exchange and OTC market activities were clearly separated and that there was no holding out or implication that, for instance, on-exchange contract guarantee and fidelity fund protections also applied to any OTC derivatives market conducted by that exchange entity.

Transactions on unauthorised markets

4.41 A derivatives transaction should not be void merely because it is entered into on an unauthorised derivatives market.[244]

Regulation of derivatives markets

Definition of derivatives market

Recommendation 7. A person should be prohibited from conducting a derivatives market unless authorised.

A "derivatives market" should be defined as:

> "any market, exchange or other place at which, or a facility by means of which, in Australia:
>
> - derivatives contracts are regularly acquired or disposed of
> - offers to enter into derivatives contracts are regularly made or accepted, or
> - information is regularly provided about the prices at which, or the consideration for which, particular persons, or particular classes of persons, propose, or may reasonably be expected, to acquire or dispose of derivatives contracts, whether or not transactions are made on or through that facility
>
> and where the ASC, in the public interest, designates the activity as a derivatives market".

In considering whether to designate an activity as a derivatives market, the ASC should take into account whether the activity might be more appropriately dealt with under the licensing provisions. No person should be subject to both derivatives market regulation and derivatives licensing for the same activity.

Authorising derivatives markets

Recommendation 8. Any applicant for authorisation of a market that involves fungible derivatives transactions (that is, any standardised agreements that are fully interchangeable with substitute transactions of the same class) and from which retail end-users are not excluded should only be authorised to conduct a financial exchange. There should be a prohibition on persons holding out or implying that they conduct a financial exchange unless they have been so approved.

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244 Compare s 103(2)(a); ASC Policy Statement 100 para 11.

Any applicant for authorisation as an OTC derivatives market should be required to show that the market will be conducted in a fair and orderly manner. Any authorisation could be made subject to minimum standard conditions.

The ASC should have appropriate powers to ensure the fair and orderly conduct of OTC derivatives markets.

A derivatives transaction should not be void merely because it is entered into on an unauthorised derivatives market.

Authorising financial exchanges

A uniform approach

4.42 The Financial System Inquiry has proposed a single authorisation procedure for all financial exchanges, applying a principles-based approach using fairness and efficiency criteria.[245] Currently, there are generally comparable criteria for authorising a securities exchange or a futures exchange.[246] These criteria could be standardised for all financial exchanges to include:

- the suitability of the applicant[247]
- appropriate business rules
- adequate contract protection for transactions taking place on the exchange
- satisfactory arrangements to prevent trading defaults by exchange members
- adequate compensation arrangements
- whether the public interest will be served by granting the application.

4.43 Following is a discussion of how these core financial exchange criteria should apply in permitting derivatives trading on a financial exchange.

The SFE and ASX as financial exchanges

Preserving current arrangements

4.44 The SFE and ASX should be automatically authorised as financial exchanges (without being required to change their names) for all classes of products for which they currently conduct a market. The current SFE and ASX arrangements for their derivatives markets work well in practice. For instance, all transactions on the SFE, and options and share ratio contracts on the ASX, are subject to novation clearing.[248] Also, the SFE and ASX both have access to funds which underwrite the transactions cleared through Sydney Futures Exchange Clearing House (SFECH) and Options Clearing House[249] respectively. Transactions on the SFE are supported by assets held

245 *Financial System Inquiry Final Report* Recommendation 21.

246 cf ss 769, 1126.

247 Compare ASC Policy Statement 100 para 63(a).

248 See SFE General By-law G.1, SFECH art 3(1), By-laws 30, 31, ASX r 10.5.

249 The Advisory Committee recognises that warrants traded on the ASX are not cleared by Options Clearing House.

by SFECH and other assets to which SFECH has access.[250] Likewise, transactions on the ASX are backed by assets held by the National Guarantee Fund (NGF).[251]

4.45 The SFE would have the right to conduct a market in the following derivatives:

- all futures contracts for which they have approved business rules, and
- all contracts that have been prescribed under s 72A as at the date of the amending legislation, including deliverable share futures and deliverable bond futures.[252]

4.46 The ASX would have the right to conduct a market in the following derivatives (in addition to its market in securities):

- LEPOs
- warrants
- other Chapter 7 options, and
- all contracts that have been prescribed under s 92A as at the date of the amending legislation, including share ratio contracts.

4.47 Sections 72A and 92A, which were introduced to permit the SFE to conduct a market in contracts that may not be futures and the ASX to conduct a market in contracts that may not be not securities, should be repealed upon enactment of the amending legislation.[253]

Other classes of derivatives

4.48 The SFE and ASX, as financial exchanges, should be entitled to conduct a market in any other class of derivatives, provided:

- the business rules for that class of derivatives have been approved, and
- there are satisfactory contract protection arrangements[254] for conducting a market in that class of derivatives.

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250 SFECH is a wholly owned subsidiary of the Exchange. It is financially supported by the SFE, SFECH members and catastrophe insurance to provide $100 million in backing against defaults by clearing house members. SFECH By-laws 5 and 6 deal with the financial obligations of clearing members.

251 The Securities Exchange Guarantee Corporation (SEGC), a subsidiary of the ASX, administers the NGF ($143 million at June 1996). Its purpose is to guarantee completion of trades, and provide compensation for unauthorised transfers of quoted securities or loss of property held on trust by brokers who become insolvent. Under Part 7.10 Div 4, levies may be imposed on dealers if the NGF is less than the statutory minimum amount.

252 Corp Regs 1.2.12 ff.

253 According to one commentator, these provisions tend "to fragment further the law regulating the trading of exchange-based derivatives and add one more dimension, and resultant complexity, to the trading of derivatives generally": F Donnan, "The Share Ratio Act: Innovation or Experimentation in Securities Regulation?" (1996) 14 *Company and Securities Law Journal* 101 at 108.

254 Recommendation 12.

4.49 Also, if the ASX proposes pooled contract protection resource backing for its combined derivatives and securities markets, it should obtain separate approval for those arrangements.[255] The same requirement should apply to the SFE if it sought to conduct a market in securities as well as derivatives, and proposed a pooled resource backing arrangement.

Authorising other entities as financial exchanges

4.50 Competition and product innovation in the financial market may be encouraged through financial exchanges, additional to the ASX and SFE, being established to conduct a market in derivatives. These exchanges might provide markets for a more limited range of products for particular participants. The Financial System Inquiry acknowledged that the establishment of new exchanges could lead to market fragmentation and duplication of overhead costs. However, the Inquiry Report said that it "does not believe these concerns should preclude the entry of new exchanges".[256] The Advisory Committee agrees. The survival of particular exchanges should be left to market forces.

4.51 The criteria for authorising other entities as financial exchanges are intended to ensure fair, orderly and effective trading, price discovery and contract protection on these exchanges.

The authorisation process

4.52 Currently, futures exchanges and securities exchanges must be approved by the Minister.[257] There is no procedure for further review of a previously granted exchange authorisation.

4.53 The Advisory Committee considers that any body corporate could seek to be authorised to operate a financial exchange that conducts a market in derivatives. The Advisory Committee notes the Financial System Inquiry recommendation that the powers of approval be given to the Commission rather than the Minister.[258]

4.54 Currently, the Minister may disallow amendments to the business or listing rules of any exchange, clearing house or futures association.[259] The same disallowance procedure should apply to financial exchanges (including the ASX and SFE), any clearing house or other organisation providing contract protection for exchange trading in financial instruments and any other relevant self-regulatory body. The Advisory Committee notes that the Financial System Inquiry has recommended that the rule disallowance powers be given to the Commission rather than the Minister, given that rule changes involve technical issues that may not warrant the Minister's attention and which could slow down the approval process.[260]

255 paras 4.116-4.120, post.
256 *Financial System Inquiry Final Report* at 281.
257 ss 769 (stock exchanges), 1126 (futures exchanges).
258 *Financial System Inquiry Final Report* Recommendations 2, 23.
259 ss 774, 779C, 1136.
260 *Financial System Inquiry Final Report* Recommendation 5.

Intermediated financial exchange

4.55 An applicant for authorisation as an intermediated financial exchange to conduct a market in derivatives would have to satisfy the core financial exchange authorisation criteria and additional derivatives criteria. These core and specific criteria are outlined below.

Business rules

(i) Core criteria

4.56 The Advisory Committee considers that the proposed business rules of an applicant for authorisation as a financial exchange should apply to all persons acting as principals on that exchange,[261] and should cover the following matters:

- qualifications of persons who will be subject to these business rules (members), including their experience and financial resources[262]
- procedures for disciplining members[263]
- inspection and audit of accounting records[264]
- conditions of dealing on the exchange[265]
- procedures for resolving disputes between members and between members and their clients[266]
- ensuring that trading takes place in an informed, orderly and fair market[267]
- enabling the exchange to supervise its market and members and monitor compliance with the rules,[268] and
- carrying on business in the interests and for the protection of the public.[269]

4.57 The court should have the power to enforce the business rules.[270]

(ii) Derivatives criteria

4.58 A financial exchange could conduct a market in any class of derivatives for which it has satisfactory business rules. These business rules would cover such matters as product specifications for particular classes of derivatives, any particular qualifications and experience required for members to deal in these classes and any additional settlement requirements for these classes.

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261 Compare ASC Policy Statement 100 para 63(b), (c).
262 s 1126(2)(c)(i), (ii), (iiia), (iv). See also ASC Policy Statement 100 paras 22, 63(d).
263 s 1126(2)(c)(v), (vi), (vii).
264 s 1126(2)(c)(viii). See also ss 864, 1123.
265 s 1126(2)(c)(iii), (ix), (xi), (xii), (xiii), (xiv), (xv).
266 s 1126(2)(c)(xvi), (xvii). See SFE arts 39, 40. See also ASX Business Rule Guidance Note 1/97 "Complaint Handling Procedures" (9 April 1997).
267 Compare ASC Policy Statement 100 paras 23-29, 63(h).
268 For instance, ASX r 1.4.2(2). Compare ASC Policy Statement 100 paras 35, 63(e).
269 s 1126(2)(c)(xviii).
270 s 1140.

Contract protection

(i) Core criteria

4.59 There are various possible forms of contract protection for financial exchanges.[271]

(ii) Derivatives criteria

4.60 An applicant should be required to demonstrate that its contract protection arrangements are satisfactory for the classes of derivatives for which it will provide an exchange market.[272]

Arrangements to prevent trading defaults

(i) Core criteria

4.61 Exchange members may reduce the possibility of defaulting on their trading obligations by implementing appropriate risk management systems.[273] These systems are not required under the Corporations Law. Rather, current SFE and ASX business rules require members to maintain adequate internal arrangements to perform their functions.[274] These arrangements could involve risk management systems, including separation of settlement and trading functions. The exchanges also require that their members' internal control procedures be audited.[275] Any applicant for authorisation as an intermediated financial exchange should have comparable control arrangements in its business rules.

(ii) Derivatives criteria

4.62 There are no additional criteria for an applicant to conduct a market in derivatives.

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271 See further paras 4.75-4.79, post.

272 Refer paras 4.74-4.124, post.

273 The *Futures Industry Association Financial Integrity Recommendations* (June 1995) Recommendations 17, 45 and 46 propose that each exchange/clearing house should have and enforce appropriate risk management procedures for clearing members. The Bank of England *Report of the Board of Banking Supervision Inquiry into the Circumstances of the Collapse of Barings* (July 1995) indicated that the collapse was due to the lack of a proper internal risk management system (primarily one trader being able to act without authority and detection) and not by trading in derivatives products as such. The Report made a number of recommendations about appropriate risk management systems for brokers: paras 14.2, 14.3.

274 See, for instance, SFECH By-laws 4.4(e), 4.8 and ASX r 10.2.1.3(c).

275 SFE art 3.6(3)(b)(iv) and Eighth Schedule to SFE Articles and By-laws, ASX r 1.3(10). This is consistent with international best practice: *Futures Industry Association Financial Integrity Recommendations* (June 1995) Recommendation 16.

Compensation arrangements

(i) Core criteria

4.63 Currently, the SFE and ASX must maintain compensation funds, available to clients of brokers.[276] The SFE maintains a fidelity fund,[277] while clients of ASX securities dealers are compensated from the NGF.[278] Both funds cover defalcations, or fraudulent misuse of client funds, by brokers.[279] However, only the NGF provides compensation for loss of client property entrusted to brokers who subsequently become insolvent.

4.64 Applicants for authorisation as an intermediated financial exchange should have compensation arrangements to cover all clients' assets held by on-exchange brokers, at least for defalcation and fraud.[280]

(ii) Derivatives criteria

4.65 An applicant should be required to demonstrate that its compensation arrangements are satisfactory for the classes of derivatives for which it will provide a market.

4.66 The SFE Submission was that a fidelity fund for derivatives should only cover defalcations or fraudulent misuse of client funds. It should not protect clients against the insolvency of a broker (whether or not caused by default of other clients of that broker), or guarantee member-client contracts. The client could be indirectly protected through any clearing house capital requirements for members. However, the ASX considers that retail participants have no real means to assess the financial position of members and that extending the compensation arrangements to the insolvency of members properly protects those clients.

4.67 The Advisory Committee considers that fidelity funds for financial exchanges that are authorised to conduct a derivatives market should cover all deposits by clients for the purpose of their derivatives trading, including funds for possible future margin calls. These funds should compensate clients for any losses arising from the misappropriation or misuse of their assets, whether or not their broker is insolvent. However, the fidelity fund should not cover outright loans by clients to exchange brokers (that is, to be used by brokers on their own account, rather than on their clients' behalf) or any OTC trading by these brokers.[281]

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276 ss 769(2)(e), 1126(2)(d).

277 Part 8.6.

278 Part 7.10 Divs 6-8.

279 See, for instance, s 1239.

280 The NGF does not cover failures by issuers of ASX-traded warrants. The same principle should apply to warrants traded on any financial exchange.

281 The Advisory Committee agrees with the submissions referred to in the ASC's *Report on Over-the-Counter Derivatives Markets* (May 1994) para 96 that the fidelity fund provisions should not apply to OTC dealings in derivatives.

4.68 The SEGC *On-exchange Submission* argued that where an entity is a member of the clearing house of a financial exchange that is permitted to conduct a market in both derivatives and securities, there may be a potential for overlap, with a client dealing in derivatives over securities being potentially entitled to claim against the securities and derivatives fidelity funds, if separately maintained.[282] The Advisory Committee considers that an applicant should be required to identify the means of resolving this matter, including the method for identifying primary liability.

Public interest

4.69 An applicant would have to show that the public interest will be served if the application is granted.[283] This general criterion might be satisfied by the applicant demonstrating, for instance, that approval of its application could increase competition, encourage product innovation, or otherwise benefit market participants. However, an application should not be denied merely on the basis that a new exchange could lead to market fragmentation or duplication of overhead costs.[284] The public interest criterion could also be used to ensure that financial exchange business rules do not include matters detrimental to market participants.

Disintermediated financial exchanges

4.70 Technological developments have the potential to alter the character of exchange trading, for instance by reducing or eliminating the role of brokers as intermediaries.[285] End-users could transact on the exchange themselves, directly satisfy any clearing margins, and themselves settle contracts electronically. This could encourage the development of disintermediated exchanges. The regulatory controls should be sufficiently flexible to accommodate these exchange arrangements.

4.71 To be authorised as a disintermediated financial exchange, an applicant would have to meet the core financial exchange criteria. These criteria should be the same as the core criteria for intermediated exchanges, but adapted to take into account the absence of brokers. For instance, there would be no need for rules governing arrangements to prevent trading defaults or compensation arrangements. The court should have the power to enforce the business rules.[286]

4.72 If authorised, a disintermediated financial exchange would be entitled to conduct a market in any class of derivatives for which it has satisfactory business rules. These business rules would cover such matters as product specifications for particular classes of derivatives and any additional settlement requirements for these classes.

282 This matter is further discussed at paras 4.116-4.120, post.

283 s 1126(2)(e).

284 Refer para 4.50, supra.

285 The *Financial System Inquiry Final Report* at 115 noted that: "In other countries, computerised markets allow investors to trade directly among themselves without the use of intermediaries".

286 s 1140.

Authorising financial exchanges

SFE and ASX

Recommendation 9. The SFE and ASX should be automatically authorised as financial exchanges for all classes of products for which they provide a market before enactment of the relevant amending legislation.

The SFE and ASX, as financial exchanges, should be entitled to conduct a market in any other class of derivatives whose business rules have been approved and for which they have satisfactory contract protection arrangements. These exchanges should also be required to obtain separate approval if they seek to pool the contract protection resource backing for any combined derivatives and securities markets.

Other financial exchanges

Recommendation 10. Any other body corporate should be permitted to seek authorisation as a financial exchange that conducts a market in derivatives.

An application for authorisation to conduct an intermediated financial exchange should demonstrate:

- the suitability of the applicant
- appropriate business rules
- adequate contract protection for transactions taking place on the exchange
- satisfactory arrangements to prevent trading defaults by exchange members
- adequate compensation arrangements
- that the public interest will be served by granting the application.

An application for authorisation to conduct a disintermediated financial exchange should demonstrate:

- the suitability of the applicant
- appropriate business rules
- adequate contract protection for transactions taking place on the exchange
- that the public interest will be served by granting the application.

An intermediated or disintermediated financial exchange should be permitted to conduct a market in any class of derivatives if it has satisfactory business rules for those derivatives covering, for instance, product specifications, any particular qualifications and experience required for intermediaries to deal in those derivatives and any additional settlement requirements for these classes.

An intermediated or disintermediated financial exchange should only be able to establish a market in derivatives or introduce new classes of derivatives if it can demonstrate that:

- its contract protection arrangements will be adequate to accommodate the additional derivatives
- its compensation arrangements will remain adequate after the new derivatives have been introduced.

All financial exchanges

Recommendation 11. There should be a power to disallow amendments to the business rules of any financial exchange, clearing house or other organisation providing contract protection for trading in financial instruments, and any other relevant self-regulatory body.

Contract protection

Nature of contract protection

4.73 The notion of contract protection, at its broadest, refers to any formal mechanisms for recording and settling on-exchange or OTC derivatives transactions. These mechanisms can provide a range of contract protection, including.

- full counterparty credit risk protection (for instance, under novation clearing)
- partial counterparty credit risk protection (for instance, under some counterparty credit control mechanisms), or
- contract confirmation and settlement protections only (as under some current OTC clearing arrangements).

The netting aspects of clearing and settlement processes are dealt with in the CASAC Netting Sub-Committee Final Report *Netting in Financial Markets Transactions* (June 1997).

On-exchange

4.74 The current exchange mechanism involves anonymous trading, with parties contracting without the benefit of counterparty credit assessment. Instead, participants rely on exchange contract protection arrangements to deal with counterparty credit risk.

Types of on-exchange contract protection

4.75 There is an increasing range of contract protection mechanisms that could be utilised for on-exchange derivatives markets. Some of these are set out below. Other contract protection structures may emerge in the future for exchange markets involving particular classes of derivatives or particular participants. However, the essential requirement for any contract protection mechanism for an exchange derivatives market is a satisfactory method of controlling counterparty credit risk. The other risks arising from on-exchange derivatives trading should either be borne by the transacting parties[287] or be dealt with through other reforms.[288]

Novation clearing

4.76 The usual form of contract protection for on-exchange futures transactions is novation clearing. It applies, for instance, to all futures contracts traded on the SFE[289] and options and share ratio contracts traded on the ASX.[290] Novation clearing involves the clearing house entering into substitute contracts with each of the counterparties (being the clearing house members, not their clients) for every contract it confirms and registers, in substitution for the original contracting parties.[291] Novation clearing transfers continuing counterparty credit risk from the original contracting parties to the clearing house which becomes the centralised manager of these risks.[292] The contractual rights of those parties who comply with their contractual obligations will be met independently of the financial ability of their original counterparties. The clearing house protects itself against this concentrated risk through a system of capital backing, margin requirements and close-out powers.

Title transfer clearing

4.77 An alternative clearing arrangement appropriate for securities and some derivatives is title transfer clearing. It involves matching of the terms of trade (matching), calculation of the resulting obligations of counterparties (clearance), and discharge of those obligations (settlement) through transfer of securities (delivery), transfer of funds (payment) and registration of transfers.[293] In contrast to novation clearing, the clearing house does not become a counterparty to any transactions.

4.78 In the derivatives context, title transfer clearing applies to trading of warrants on the ASX, given their particular characteristics.[294] In this instance, clearing members

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287 Participants should bear market risk (paras 2.31-2.32, supra), large exposure risk (paras 2.37-2.38), market liquidity risk (para 2.39) and operational risk (paras 2.42-2.43). The consequences for participants of their exposure to market risk and large exposure risk can be dealt with through clearing house margining requirements and close-out powers for defaults.

288 The other risk arising from on-exchange trading is legal risk (paras 2.44-2.45, supra). Ultra vires is discussed at paras 8.95-8.113, post. Gaming and wagering legislation is discussed at paras 8.114-8.115, post. The CASAC Netting Sub-Committee Final Report *Netting in Financial Markets Transactions* (June 1997) recommends legislation to cover bilateral and multilateral netting.

289 See SFE General By-law G.1, SFECH art 3(1), By-laws 30, 31.

290 ASX r 10.5.

291 Brokers are principals to the original contract, even when acting on behalf of their clients. The clearing rules relate to all contracts entered into between clearing members, either on their own, or on their clients' behalf, once registered with the clearing house. These rules do not extend to member-client contracts, which are covered by the compensation arrangements.

292 A clearing house is not exposed to market risk, given that it is the counterparty to both sides of every transaction.

293 s 779B(2)(a).

294 All warrants currently traded on the ASX are settled through CHESS. The NGF applies to this secondary trading of warrants on the ASX. However, performance by the warrant issuer is not guaranteed by the NGF. The final transfer of shares on exercise of the warrant is effected off-market between the warrant issuer and the ultimate holder of the warrant. The Offering

have a claim against the guarantee fund to protect their rights under the on-exchange contract.[295]

Counterparty credit controls

4.79 A possible alternative to clearing that might in future be adopted for some specialised exchanges that conduct a market in derivatives is counterparty credit controls. For instance, those exchanges could offer standardised capped contingent liability transactions, supported by an exchange mechanism to ensure that the total possible liability of participants within that cap is fully covered by their credit capacity. Alternatively, participants could indicate the level of counterparty credit risk they are willing to bear for particular counterparties, or the credit standing requirements of potential counterparties, with the exchange mechanism randomly matching parties only within those specifications, and thereafter providing confirmation and settlement facilities.

The on-exchange authorisation process

4.80 Currently, clearing house arrangements must be approved by the Minister.[296] There is no procedure for further review of a previously granted authorisation as a clearing house.

4.81 An authorisation process could apply for any form of on-exchange contract protection authorisation. The Financial System Inquiry recommended that the Commission, rather than the Minister, should be responsible for authorising financial exchange clearing mechanisms, taking into account the appropriateness of the proposed clearing and settlement arrangements for controlling counterparty credit risk.[297]

Requirements for effective on-exchange novation clearing

4.82 The remaining discussion of on-exchange contract protection focuses on novation clearing, given that it is currently the most common form of on-exchange contract protection.

4.83 The Financial System Inquiry noted that clearing houses take on major financial risks in the event of counterparty failure and are essential to the proper functioning of financial markets. Australia's international standing could be adversely affected by reducing the current regulation of clearing houses.[298]

Circular prepared by the warrant issuer (ASX r 8.7) is intended to assist purchasers of warrants in assessing this counterparty credit risk.

295 Part 7.10 Divs 6, 6B.

296 Section 1131 sets out the criteria for Ministerial approval of a clearing house, including that the Minister may have regard to "any business rules of the applicant that relate to the guaranteeing, to members of the applicant, of the performance of futures contracts made on a futures market of the futures exchange".

297 *Financial System Inquiry Final Report* Recommendation 24.

298 id, at 284-285.

4.84 The Advisory Committee recognises that, worldwide, clearing houses are organised in a wide variety of forms. Some clearing houses are departments or subsidiaries of exchanges; others are independent legal entities. Some clearing houses provide services to only one exchange, while others serve a group of exchanges. Despite these differences, clearing houses that offer novation clearing typically have core common features to provide contract protection to market participants and to maintain their own financial integrity.

4.85 The Advisory Committee considers that any novation clearing arrangements for on-exchange derivatives transactions in Australia should ensure contract performance from the time the clearing house registers exchange-traded derivatives contracts and thereby takes upon itself the counterparty credit risk and any legal risk involved. The ability of these clearing arrangements to provide that guarantee, without the clearing house risking collapse and thereby creating market systemic risk, depends on there being:

- adequate mechanisms to minimise defaults (*risk controls*)
- sufficient resources held by the clearing house to cover any defaults (*resource backing*), and
- periodic evaluation of these risk controls and resource backing (*stress testing*).

4.86 The *Futures Industry Association Financial Integrity Recommendations* identified various matters as international best practice to ensure contract performance under novation clearing arrangements, given these financial risks. These included:

- adequate methods for determining margin payments, using appropriate risk-assessment systems and, at least, daily marking- or margining-to-market of all open positions
- obligations on clearing members to promptly collect margins from clients
- appropriate open position limits to control the risks assumed by members through their own, or their clients', trading
- appropriate obligations on clearing members to monitor the credit position of their clients
- suitable methods to identify the size and ultimate beneficial ownership of client positions
- adequate powers and audit procedures to ensure that members comply with clearing house risk control requirements
- adequate mechanisms to facilitate the prompt transfer or close-out of positions of a defaulting member

- adequate resources available to the exchange or clearing house to cover any defaults by clearing members.[299]

4.87 A Report by the Bank for International Settlements has stated that both the liquidity of exchange-traded derivatives markets and the timely completion of contractual obligations entered into in these markets are critically dependent on the operational and financial integrity of exchange clearing houses, in which the counterparty credit and other financial risks of exchange-trading are concentrated.[300] The Report pointed to a number of factors which are fundamental to achieving clearing house integrity, including:

- margin requirements that limit the financial exposures of members by periodically settling gains and losses
- risk-based position limits and other risk management requirements for membership of clearing houses
- procedures that authorise prompt resolution of a clearing member's default through the clearing house closing out the member's positions and transferring (to a non-defaulting clearing member), or closing out, the positions of the defaulting member's clients
- the maintenance of satisfactory clearing house financial resources, including capital, asset pools, credit lines or guarantees, and
- stress testing to identify the implications for risk controls of extreme price movements and to ensure that the clearing house's financial resources are of adequate size and liquidity to cover possible defaults by clearing members.

4.88 The Advisory Committee considers that any novation clearing for on-exchange derivatives trading should be consistent with these international principles.

Risk controls

4.89 Under clearing house arrangements worldwide, clearing houses deal with, and impose risk controls on, their members, not the clients of their members, given that the members act as principals for all on-exchange transactions. This ensures that the risk control mechanisms can be properly imposed and enforced.

4.90 *Margining.* The purpose of margining is to ensure that in the event of any default by a clearing member, most of the possible losses on open positions held by that member (on its own account or on behalf of clients) are covered by previously collected margins.

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299 *Futures Industry Association Financial Integrity Recommendations* (June 1995). Similar views have been expressed in other reports on futures exchanges. For instance, the Report of the Securities Review Committee, *The Operation and Regulation of the Hong Kong Securities and Futures Industry* (May 1988) (Davison Report) stated (at para 7.2) that "the system of margining, daily settlement and clearing house surveillance of members is the bedrock upon which a well founded futures market must be based".

300 Bank for International Settlements, *Clearing Arrangements For Exchange-Traded Derivatives* (March 1997).

4.91 The task in developing a margining system is to strike a balance between the risk reduction benefits to a clearing house of making financial calls on clearing house members, and the opportunity costs to these members (and their clients) in complying with these calls. A margining system that is not sufficiently rigorous may put a clearing house at a greater financial risk of defaults by members. Conversely, a margining regime that is too severe could place an on-exchange market at a competitive disadvantage to an OTC derivatives market, which is not subject to any equivalent mandatory margining requirements.[301]

4.92 Under margining, derivatives contracts are marked-to-market and current exposures are covered by providing cash payments or other collateral to the clearing house. Initial margin (which must be deposited with the clearing house before it registers the contract) and variation margins (funds to cover any notional losses or liabilities that arise during the life of the contract) are set by the clearing house or the exchange.[302] However, practices differ internationally as to whether derivatives option contracts should be subject to variation as well as initial margins.[303]

4.93 The effectiveness of a margining system depends on:

- *the percentage of potential losses to be covered.* Most clearing houses throughout the world have tended to set margins at levels intended to cover from 95% to 99% of potential losses from movements in market prices over a one day time period[304]

- *the frequency of settling margins.* The most common requirement is one settlement at the end of each trading day, though some clearing houses provide for intra-day settlements and margin calls to further reduce any clearing house exposure, particularly to price volatile derivatives.[305] For on-exchange clearing in Australia, a settlement price on all positions at the clearing house should be determined by marking or margining them to market, at least daily.[306] Clearing members carrying a net loss should pay a

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301 The CSR *On-exchange Submission* pointed out that, for corporates, OTC rather than exchange-traded contracts may be better hedging instruments, given the extra administration involved in managing and accounting for exchange margin calls.

302 SFE General By-law G.2. The initial margin is calculated by reference to likely intra-day price movements. During periods of extreme market volatility, initial margins may be increased. See also ASX rr 10.9.1, 10.9.2.

303 Bank for International Settlements, *Clearing Arrangements For Exchange-Traded Derivatives* (March 1997) at 21.

304 id at 22.

305 id at 23.

306 See ASX r 10.9.1. Margining of ASX-traded equity derivatives is through the Theoretical Intermarket Margining System (TIMS) which provides daily (or more frequent) margining of positions.
Each business day, SFECH marks-to-market registered open contracts using the Standard Portfolio Analysis of Risk method. Under this method, all exchange contracts are notionally "closed out" at prevailing market prices, the profit or loss on each is calculated, and each clearing member is required to provide additional funds to the clearing house to cover net losses. Normally, this margining process occurs daily. However, in periods of extreme market volatility, intra-day margin calls may be made. See also SFE General By-laws G.2, G.4, OPT.7 and OPT.9, SFECH By-laws 44, 45.

variation margin to the clearing house.[307] The clearing house should control the transfer of funds on at least a daily basis to settle all losses and gains. Clearing members should be obliged to collect initial and variation margins from clients promptly after receiving margin calls from the clearing house.[308] Members should have appropriate powers to close out clients' contracts on default[309]

- *the types of assets acceptable as margin collateral.* Clearing houses differ in the types of assets they accept, in addition to cash, as collateral for margin requirements.[310] These may include bank guarantees, listed shares and approved money market instruments.[311] The Advisory Committee considers that the business rules of an Australian exchange or clearing house should determine what types of asset are acceptable. The Netting Sub-Committee Report makes recommendations to ensure that the clearing house has the benefit of the full value of collateral in the event of the insolvency of a collateral giver[312]

- *the separation of clearing members' own transactions (house positions) from their clients' positions.* The usual practice is for clearing houses to require brokers to hold the funds for their house positions and their clients' positions in separate accounts. This is the practice in Australia, though some overseas exchanges permit house and customer funds to be combined for the purpose of calculating margin obligations. The Advisory Committee considers that the latter practice is unsatisfactory.

4.94 *Position limits.* It is common, but not universal, practice for novation clearing arrangements to limit the size of aggregate open positions held by individual members, on their own or their clients' behalf. These position limits can serve regulatory as well as prudential purposes.[313] Some clearing houses employ risk-based position limits, for instance, by determining position limits according to a member's capital base.

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307 Separate margin calls are made in respect of brokers' house positions and client positions. These house and client funds are held in separate accounts.

308 SFE General By-laws G.4 and OPT.9.

309 SFE General By-laws G.3 and OPT.8 provide that a clearing member may close out the positions of a client who fails to meet margin calls paid by the member to the clearing house.

310 Moodys Investors Service, *Credit Risks of Clearing Houses at Futures and Options Exchanges* (June 1995) at 14; Bank for International Settlements, *Clearing Arrangements For Exchange-Traded Derivatives* (March 1997) at 22-23.

311 SFE General By-law G.2(a)(iii) and Part A of the First Schedule to the Business Rules, ASX r 12.1 definitions of "Cover" and "Collateral".

312 CASAC Netting Sub-Committee Final Report *Netting in Financial Markets Transactions* (June 1997). The Legal Committee of the Advisory Committee published a Discussion Paper *Voluntary Insolvency Administration* in January 1997. In making its final recommendations, the Legal Committee will take into account the need to preserve this collateral for the benefit of the clearing house.

313 For instance, some clearing houses impose these limits primarily to inhibit the ability of market participants to manipulate prices, particularly for contracts for which the deliverable supply is limited. Refer Bank for International Settlements, *Clearing Arrangements For Exchange-Traded Derivatives* (March 1997) at 26.

4.95 In Australia, current exchange practice is to impose aggregate open position limits on members when trading in derivatives.[314] These limits are determined by reference to the net tangible assets held by members. The Advisory Committee supports the exchanges having this power, and being able to set any open position limits by reference to a member's entire financial markets trading portfolio, not simply derivatives transactions.[315]

4.96 Some overseas clearing houses have granted exemptions for large positions deemed to be hedges. The rationale for these exemptions is that profits or losses on the hedging position are offset by profits or losses on the hedged position. However, the Advisory Committee notes that there can be a mismatch between the hedging and the hedged positions which may result in considerable losses.[316] For this reason, the Committee considers that any proposed clearing arrangements that involve position limit exemptions for hedged transactions should be treated with considerable caution.

4.97 *Capital requirements for members.* Novation clearing members should be subject to capital standards set by the exchange or clearing house to offset the financial risks of their own derivatives trading, and the possible defaults of their clients, given that they act as principals in all on-exchange trading.[317] These minimum capital requirements could take into account the link between capital and risk management systems, and be adjustable accordingly.[318] These requirements would reduce, but not necessarily eliminate, the possibility of financial default by members, particularly in a highly price-volatile market.

4.98 *Identifying clients for credit assessment.* The benefit of members being able to determine the ultimate identity of their clients is to enable them, where necessary, to assess their clients' actual exposure and consequent ability to meet margin calls. This assessment helps protect members against the possible failure of their clients to meet margin or settlement novation clearing requirements. These failures could lead to the insolvency of members (who are obliged to honour clearing house margin calls on

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314 Position limits are dealt with, for instance, in ASX r 7.10.1, SFE General By-laws G.16-19, SFECH By-law 9. An SFE clearing member may not hold positions with an aggregate initial margin liability in excess of 300% of its net tangible assets. Compare SFE art 3.6(3)(n) which provides that a member may not permit any one client to represent such a percentage of that member's trading as to prejudice or diminish the ability of the floor member to meet its obligations.

315 RBA *On-exchange Submission*.

316 Moodys Investors Service, *Credit Risks of Clearing Houses at Futures and Options Exchanges* (June 1995) gives examples of exemptions granted on the basis of advice from members about the hedging character of the transaction only to find that this was not an apt characterisation or other factors made the position excessively risky.

317 Clearing members are required to maintain a minimum value of net tangible assets. See, for instance, SFECH By-laws 8.1-8.3, Section 1 of Schedule 9. For current capital liquidity requirements, see ASX rr 1.1, 10.2.1.3(a), 10.2.2, SFE art 3.6(3)(a). The SFE monitors compliance with these capital requirements by requiring interim returns by members, including a statement of funds held by members on behalf of their clients (SFE arts 3.6(3)(b), 4.6(4)(c), SFECH By-law 8.4) and immediate notification if the value of a member's financial position is at any time less than 150% of the financial requirements (SFECH By-law 8.5).

318 paras 6.2, 6.30-6.33, post.

behalf of their clients) and, if sufficient funds are involved, place financial pressure on the clearing house.

4.99 Client identification requirements could take various forms. For instance, there could be mandatory beneficial interest disclosure requirements in client agreement forms. Alternatively, members could be required to ascertain the identity of the beneficial owner of an account having more than a specified number of open positions. However, neither obligation would necessarily ensure accurate identification of the ultimate client. Also, clearing members may have difficulty in applying the open position rule due to lack of knowledge of their clients' OTC derivatives transactions or their transactions on overseas exchanges or other financial markets. The Advisory Committee notes international information-sharing initiatives that may assist in detecting large exposures built up by a person trading on several exchanges.[319] However, this information may not reveal a person who has moderate exposures on various exchanges which in combination amount to a large exposure.[320] This points to the importance of other risk control mechanisms.

4.100 *Surveillance and disciplinary powers.* The exchange or clearing house should have adequate audit and other inspection powers to supervise members in complying with their margining, position limit,[321] capital and other relevant clearing obligations.[322] The Davison Report into the Hong Kong securities and futures industry took a similar view:

> "Checking that a firm has met today's margin call in respect of yesterday's trading is reactive. The concern should be whether, given a [member's] overall financial position, it will be able to meet tomorrow's margin call in respect of today's trading. In our view active clearing house monitoring is an essential supplement to margin collection as the clearing house is responsible for spotting credit risk problems on a day-to-day basis."[323]

4.101 The Advisory Committee supports the "amber light" system designed to trigger more intensive surveillance or other response (such as additional margin calls, increased capital requirements for affected members or reductions in their permitted

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319 *ASC Media Release* 96/42, "ASC and SFE sign international agreements to share information". The International Information Sharing Memorandum of Understanding and Agreement provides for "more timely and complete sharing among futures regulatory authorities and self-regulatory organisations, such as exchanges, of information about large futures exposures on exchanges that might put a futures trading firm, a related firm, or the whole market at risk".

320 This problem can also arise with dealers. Moodys Investors Service, *Credit Risks of Clearing Houses at Futures and Options Exchanges* (June 1995) noted the difficulties for exchange clearing houses in keeping informed of their members' activities on other exchanges and in the OTC market.

321 Moodys Investors Service, *Credit Risks of Clearing Houses at Futures and Options Exchanges* (June 1995) stated that while the SIMEX rules restricted dealers to three thousand open positions, Barings had entered into more than five times that number of open contracts on SIMEX in a single day.

322 For instance, ASX r 10.2.4, SFE arts 3.6(3)(b), 13.1(b).

323 Report of the Securities Review Committee, *The Operation and Regulation of the Hong Kong Securities and Futures Industry* (May 1988) (Davison Report) para 7.26.

level of open positions). For instance, members could be required to notify the clearing house if:

- their capital falls below 150% of the regulatory minimum (or falls any subsequent 20%)[324]
- they exceed their position limits,[325] or
- their initial margin obligations exceed 80% of their net tangible assets.

4.102 This additional reporting requirement would ameliorate the problem that periodic disclosures are insufficient for surveillance purposes, as a member's financial position can rapidly and materially change within a reporting period, given the leverage and liquidity provided by modern financial markets.[326]

4.103 In addition, the clearing house business rules should make satisfactory provision for the expulsion, suspension or disciplining of members for a contravention of the clearing business rules or a relevant provision of the Corporations Law.[327]

4.104 *Sharing information about members.* The financial position of some clearing members cannot be accurately assessed without information on their activities in other on-exchange and OTC financial markets. In the international context, exchanges, clearing houses and their regulators have been working to develop and expand information-sharing agreements with respect to common members.[328] In Australia, the ASX and SFE already have arrangements for sharing surveillance information with regulators and other exchanges or clearing houses.[329] The Advisory Committee supports these initiatives as one element of effective risk controls for novation clearing.

4.105 *Powers upon default by members or in market emergencies.* A clearing house should have appropriate powers to deal with defaults by members, including by promptly:

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324 SFECH By-law 8.5(a), (b).

325 SFECH By-law 8.5(c).

326 An outline of the reporting obligations for brokers under the SFE business rules is set out in *Australian Corporations Law Principles and Practice* (Butterworths), vol 3 at [8.1.0485].

327 s 1131(2)(c). See, for instance, ASX r 10.2.5, SFE art 13.

328 Bank for International Settlements, *Clearing Arrangements For Exchange-Traded Derivatives* (March 1997) at 20.

329 For instance, the SFE Committee for Inspection and Audit (CIA) may disclose to regulatory authorities and other exchanges information provided by SFE members. It may also disclose this information in other circumstances where the CIA determines disclosure to be in the interests of the SFE, its market or members: SFE art 13.3(a)-(d). Also, SFE General By-law G.19A(a)(iii) permits the SFE to disclose "Reportable Positions" or other "Open Positions" of its members to other Australian or overseas futures or securities exchanges or regulators, without the permission of the reporting member, where the SFE "is satisfied that the disclosure of the information will assist that body to perform or exercise [its] powers or functions". Subsection 1266(4) prohibits a futures broker from disclosing a client's orders, except, inter alia, as required by the business rules of a futures exchange. The ASX has powers to disclose information to the clearing house and other exchanges and clearing houses: ASX r 11.10.

- closing out the open positions of defaulting members[330]
- transferring their clients' positions and margin collateral to other non-defaulting clearing members,[331] and
- gaining access to the mandatory capital reserves of these members.

4.106 The clearing house should also have procedures to deal with market emergencies or *force majeure*.[332]

4.107 *Methods of dealing with clearing house legal risks.* The problem of a clearing house enforcing its default rights in the event of a clearing member's insolvency is overcome by enforceable multilateral netting arrangements. The CASAC Netting Sub-Committee proposes legislation to ensure that netting arrangements in multilateral market transactions are fully effective.[333]

4.108 *Methods of dealing with clearing house operational risks.* Clearing houses depend critically on their technological infrastructure, including computer and other electronic communication systems, for their effective working. For instance, the breakdown of key operational computer or other electronic hardware could heighten the financial risks to a clearing house by impairing its ability to conduct frequent margin assessments or supervise members' position limits, thereby creating the possibility of considerable exposure to members' defaults. Clearing houses need satisfactory computer and other backup arrangements to overcome this possibility.

4.109 There should be proper security over electronic data to prevent fraud or unauthorised use of information.

Resource backing

4.110 It is commonly recognised that risk control mechanisms for clearing houses cannot provide a guarantee against defaults: "Clearing houses simply cannot be made fail-safe".[334] For instance, neither the margin requirements nor the capital requirements for members would necessarily cover extreme adverse price movements over short periods. Likewise, even the most comprehensive and well-administered surveillance programme cannot be expected to detect, much less prevent, every possible breach by clearing members of their risk control obligations. In some circumstances, the clearing house would have to rely on its supplementary resources to cover any losses by defaulting clearing members and to meet its own contractual obligations on schedule.

4.111 International studies have pointed out that there are no universally accepted methodologies or standards for assessing the adequacy of clearing house resource

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330 For instance, SFECH By-laws Part 7, ASX r 10.10.2(c).

331 ASX r 10.10.2(a).

332 For instance, SFECH By-laws 81, 82, ASX rr 10.11.3-10.11.6.

333 CASAC Netting Sub-Committee Final Report *Netting in Financial Markets Transactions* (June 1997).

334 Bank for International Settlements, *Clearing Arrangements For Exchange-Traded Derivatives* (March 1997) at 29.

backing.[335] However, taking into account both national and international practice, the Advisory Committee considers that the following matters should be considered in assessing the appropriate resource backing for an Australian financial exchange that offers novation clearing for on-exchange derivatives.

4.112 *Type and extent of resource backing.* An applicant should be required to demonstrate that there is adequate resource backing to ensure that the clearing house can perform all registered contracts. Resource backing can take various forms, including readily realisable assets, members' contributions, levies on exchange transactions and external insurance.[336] The required level of resource backing can take into account the proposed margining and other risk control mechanisms. For instance, the level of resource backing could be less for arrangements that clear down to client, rather than only to broker, level.[337] However, some resource backing is necessary as an additional financial reserve to cover any defaults that might nevertheless occur.

4.113 The Advisory Committee also considers that each exchange that is authorised to conduct a market in derivatives should be required to regularly assess the amount of cover held by it as resource backing, in light of the volume of derivatives business conducted on that exchange.

4.114 *Clearing house and separate guarantor.* The Advisory Committee has considered whether it should be permissible to have a separate guarantor provide the necessary resource backing for the clearing house. Overseas experience points to a possible problem if those bodies responsible for risk controls (the exchange and clearing house) have no resource backing obligations, and therefore less incentive to enforce the risk controls fully.[338] To counter this possibility, the Advisory Committee considers that a separate guarantor arrangement is acceptable only if:

- there is a central risk taker who has a clear and central role in day to day risk management to protect its own exposure
- the backing for the central risk taker's exposure includes a satisfactory form of obligation for members to contribute to meeting these obligations, and

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335 id at 3, 26.

336 SFECH By-laws 5-7. Currently, the SFECH backing is $100 million. This figure was derived from an independent actuarial study on the theoretical maximum likely liability of the clearing house in the event of a once in 50 year price movement in a single day resulting in the failure of a significant number of clearing members.

337 ASX *On-exchange Submission*, SEGC *On-exchange Submission*. The ASX *On-exchange Submission* argued that clearing down to client account level (that is, through trust account arrangements that separately identify each client, rather than commingling each client's account in a clients' segregated account):

- overcomes the limitation of segregated accounts, that is, one client can be detrimentally affected by the default of another client
- means that it is easier to transfer non-defaulting accounts
- provides for greater margin amounts being held by the clearing house, that is, the margin obtained is the sum of the margins calculated for each individual client account.

338 Report of the Securities Review Committee, *The Operation and Regulation of the Hong Kong Securities and Futures Industry* (May 1988) (Davison Report) Chapter 7.

- the legal obligations of the guarantor to ensure contract performance are unequivocal and arise from the time each contract is registered by the clearing house.

4.115 *External resource backing.* The Advisory Committee has considered whether the clearing house (or guarantor) should seek external resource backing, for instance, through insurance cover or some other funding arrangement, such as a banking syndicate. This could be a prudent additional funding source, depending on its size, certainty and ability to be realised at short notice. It could be taken into account in assessing the adequacy of the resource backing.[339] Overseas experience points to the financial risk of totally substituting an external fund for a members' fund.[340] Rather, the clearing house (or guarantor) should have the right to call for contributions from clearing members (for instance, through a levy on continuing members), as well as having access to any external resource backing, to meet defaults.[341]

4.116 *Combining securities and derivatives resource backing.* The Advisory Committee in its On-exchange Draft Report considered whether the resource backing for securities and derivatives clearing arrangements could be pooled for a financial exchange that is authorised to conduct a market in securities and derivatives. It expressed concerns about pooling. The Committee stated that the risks undertaken by a derivatives clearing house are, in general, potentially greater than those for a securities clearing house, given the continuing counterparty credit risk in derivatives, but not securities, trading. Derivatives trading may have a greater potential to lead to a call on the resource backing of an exchange, notwithstanding that the risk controls for derivatives trading may be more comprehensive than those for securities trading.

4.117 One submission argued that, as the costs of resource backing are essentially borne by market participants, investors in lower risk securities may be overcharged as a result of the fund established by their trading being used to support the higher risk derivatives trading.[342]

4.118 The SEGC *On-exchange Submission* argued that a joint fund may improve the stability of the exchange, particularly where derivatives and securities markets are closely related (for instance, equities and equity based derivatives). It submitted that the central issue in determining whether pooled resource backing is appropriate is whether it is adequate, in view of the combined risk of the markets conducted by a financial exchange. However, if any joint fund is permitted, there should be arrangements for equitable contributions from the relevant markets.

4.119 The ASX *On-exchange Submission* argued that the key consideration is whether the risk controls and resource backing mechanisms as a whole are adequate, rather than merely focusing on possible cross-subsidisation of different categories of

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339 SFECH arrangements are supported by a combination of clearing members' guarantees and external insurance.

340 Report of the Securities Review Committee, *The Operation and Regulation of the Hong Kong Securities and Futures Industry* (May 1988) (Davison Report) at para 7.47.

341 SFECH By-law 7.1 sets out the order for calling on the various sources of funds to satisfy the clearing house's obligations in the event of default.

342 AARF *On-exchange Submission*.

risk across securities and derivatives. The ASX also referred to possible problems in mandatory separation of the securities and derivatives resource backing arrangements for a financial exchange. With two separate funds for the one exchange, each may seek to minimise its own exposure. This may create disputes between the funds about their respective liability for particular on-exchange defaults, to the detriment of market participants. There is no possibility of demarcation disputes with one pooled fund.

4.120 The Advisory Committee considers that the matters raised in these submissions could be considered in assessing the suitability of any proposed pooling arrangements for a financial exchange that proposes to conduct a market in both derivatives and securities.

4.121 *Prohibition on combining on-exchange and OTC resource backing.* Clearing houses may wish to cover OTC as well as on-exchange derivatives trading. In these circumstances, the clearing house should be required to fully separate its on-exchange and any OTC resource backing. The resources to cover any on-exchange defaults should not be available for any OTC defaults, given the fundamentally different risks in these markets.

Stress testing

4.122 An international report has emphasised the importance of stress testing as a means of periodically evaluating and strengthening clearing house risk controls and resource backing arrangements.[343]

4.123 Stress testing involves a clearing house estimating its possible exposures in consequence of extreme hypothetical market price movements for products offered on-exchange. These hypothetical movements can be based on historical data (for instance, maximum historical price changes) or on statistical modelling of potential future price movements and changes in implied volatilities of these price movements.

4.124 Periodic stress testing can be used to test the continuing suitability of risk control measures, in particular to set or review open position limits or margin collateral for clearing members. This exercise can also gauge whether the clearing house's financial resources are of adequate size and liquidity to cover possible defaults by clearing members. Australian exchanges periodically assess their resource backing through stress testing.[344]

OTC

4.125 There should be no general obligation to offer contract protection mechanisms in OTC derivatives markets. However, the nature of some OTC markets may require

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343 Bank for International Settlements, *Clearing Arrangements For Exchange-Traded Derivatives* (March 1997) at 33-34.

344 For instance, SFECH conducts regular reviews of the adequacy of its resource backing using the same actuarial methodology as for its initial resource backing determination: refer footnote 336, supra.

some form of settlement arrangements to permit them to be conducted in an orderly manner.[345]

4.126 An applicant to conduct an OTC derivatives market might propose to employ a clearing arrangement (not necessarily involving novation clearing) or other contract protection mechanism in that market, for instance, to provide an electronic confirmation and settlement system in lieu of paper settlements. Unlike on-exchange contract protection, that OTC system would not necessarily have to deal with counterparty credit risk. The reliability of any such system should be evaluated as part of the market application. In addition, the ASC should have a power to suspend the operation of this contract protection mechanism where it considers it necessary in the public interest.[346]

4.127 There may be other circumstances where parties who are not themselves conducting an OTC derivatives market seek to employ or promote a contract protection mechanism for trading on an OTC market. The ASC should have a similar power to suspend the operation of any contract protection mechanism if this is in the public interest.

4.128 Any party offering any form of OTC contract protection should be liable for any misleading or deceptive conduct in relation to the nature or operation of that mechanism.[347]

Contract protection

Recommendation 12.

On-exchange

An applicant for approval as a financial exchange should have to establish that the exchange will have satisfactory contract protection arrangements for controlling counterparty credit risk.

Where these contract protection arrangements involve novation clearing, there should be satisfactory risk controls, resource backing and stress testing arrangements.

OTC

There should be no general obligation to offer contract protection mechanisms in any OTC derivatives market, though some settlement arrangement may be necessary to permit the market to be conducted in an orderly manner.

345 cf ASC Policy Statement 100 paras 30, 31, dealing with approving entities as stock markets. For instance, the ASC takes the view that in an anonymous full trading securities market where parties to contracts do not know in advance the identity of the person with whom they will contract, there should be adequate provision for settlement services to be offered in conjunction with that market.

346 cf s 1138.

347 cf s 995.

The reliability of any contract protection mechanism proposed by an applicant to conduct an OTC derivatives market should be evaluated as part of the market application. The ASC should also have appropriate powers to supervise the operation of any contract protection mechanism employed on that market.

Any clearing house that covers OTC as well as on-exchange derivatives trading should be required to fully separate its on-exchange and any OTC resource backing.

Chapter 5. Licensing of derivatives market intermediaries

This Chapter deals with the proposed requirements for obtaining a financial markets licence endorsed for on-exchange derivatives broking or advising or OTC derivatives broking, market-making or advising.

Single financial markets licence

5.1 The Advisory Committee in its On-exchange Draft Report proposed a single financial markets licensing system for Australian derivatives, as well as securities, markets. There was general support in submissions for this approach.[348] The Financial System Inquiry also supported a generic licensing scheme for financial market participants.[349]

5.2 This single financial markets licensing system would substitute for the current separate securities and futures market licensing systems under Chapters 7 and 8 of the Corporations Law. However, the proposed new licensing system would be subject to the same administrative review procedures as apply to the current system.

5.3 The discussion to follow deals with the criteria for endorsing a financial markets licence for on-exchange derivatives broking or advising or OTC derivatives broking, market-making or advising. The one financial markets licence could be endorsed for more than one of these activities.

On-exchange

Purposes of on-exchange derivatives licensing

5.4 The purposes of on-exchange licensing are:

- *setting entry standards*, that is, requiring licensees to meet minimum standards of competence, integrity and financial soundness
- *end-user protection*, that is, regulating the conduct of intermediaries towards their clients
- *external surveillance*, that is, enabling the ASC to exercise surveillance over the activities of on-exchange licensees and, through the imposition of notification conditions on licensees, to otherwise monitor their conduct.

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348 SFE *On-exchange Submission*, ASX *On-exchange Submission*, ASC *On-exchange Submission*, Treasury (formerly Attorney-General's Department) *On-exchange Submission*, BT *On-exchange Submission*, IBSA *On-exchange Submission*.

349 *Financial System Inquiry Final Report* Recommendation 13.

On-exchange derivatives brokers

Who should be licensed

5.5 *Agency test.* Under an on-exchange licensing regime, persons should be prohibited from dealing, or holding out that they deal, in any on-exchange derivatives contract on behalf of another person, unless they hold a financial markets licence endorsed for on-exchange derivatives broking.[350] There was general support in submissions for this agency test.

5.6 *Business test.* Currently, persons must be licensed as securities dealers to carry on a securities business, whether they trade on their own or another person's behalf.[351] There is no equivalent business test for futures brokers.

5.7 A number of submissions opposed a separate business test. They considered the agency test sufficient for the on-exchange derivatives market.[352] Similarly, other submissions[353] argued that the licensing criteria should not cover persons who conduct a business of dealing directly on the exchange solely on their own account (or merely to execute orders on behalf of exchange members) (own account dealings).[354] They submitted that:

- the main objective of licensing was to regulate those acting on behalf of others
- the licensing criteria, such as educational qualifications and solvency, are designed to protect clients and are not relevant to persons conducting own account dealings
- other market control provisions such as market manipulation apply to persons conducting own account dealings
- requiring these persons to be licensed could discourage them from participating as principals in the market and thereby reduce its liquidity.

5.8 It was submitted that these persons would be better regulated through negative licensing, that is, a power to ban persons who behave improperly from acting as on-exchange principals.

5.9 By contrast, the ASC has submitted that all persons who transact as principals on an exchange (whether acting on their own account, for clients or both) should be licensed, thereby enabling their regulation in a uniform manner through the licensing regime and the business rules.

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350 Compare s 1142. The tests of acting on behalf of other persons are found in s 9 and Part 1.2 Div 4.

351 ss 780, 93.

352 Michael Hains *On-exchange Submission*, BT *On-exchange Submission*.

353 SFE *On-exchange Submission*, Representatives of SFE Locals *On-exchange Submission*, BT *On-exchange Submission*.

354 Own account dealings include those done on behalf of associates or companies in which the dealer has a controlling interest: see s 29 and the s 17 definition of associate.

5.10 The Advisory Committee considers that the licensing provisions for on-exchange brokers should not extend to any own account dealings. Licensing should primarily govern relationships between principals and their clients. An agency test only should apply. However, the ASC should have a separate power to ban persons who behave improperly from acting as on-exchange principals.

Preserving rights of existing on-exchange brokers

5.11 Existing futures and securities brokers should be entitled to continue to deal in those on-exchange derivatives products for which they are authorised at the time of enactment of the amending legislation. They would not need to obtain a new financial markets licence.

Criteria for approving new on-exchange brokers

5.12 In determining whether to grant a financial markets licence endorsed for broking in on-exchange derivatives, the ASC should apply the following core financial markets licensing criteria for on-exchange broking:[355]

- solvency
- educational qualifications and experience
- good fame and character
- efficiency, honesty and fairness
- membership of a self-regulatory organisation (SRO).[356]

5.13 *Solvency.* An applicant (or its responsible officers) should not be an insolvent under administration or an externally administered body corporate.[357]

5.14 *Knowledge and experience.* The ASC should be satisfied that the educational qualifications and experience of the applicant (or its responsible officers) are appropriate for acting as an on-exchange broker.[358] This criterion encompasses:

- knowledge (applicants should be able to demonstrate the adequacy of their knowledge of matters relevant to their area of expertise), and
- skills (applicants should have sufficient analytical and communications skills to apply their knowledge to practical situations).[359]

5.15 The ASC, in consultation with the exchanges on which derivatives are traded and any other organisations representing brokers, could develop and apply appropriate minimum standards.[360] The Commission should also have the power to delegate

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355 The criteria are based on those for futures and securities licensees: ss 783, 784, 1144A, 1145.

356 This criterion currently applies only to futures brokers licensees: s 1144A(2)(c).

357 ss 783(2)(b), 784(2)(b), 784(4)(a), 1144A(2)(b), 1145(2)(c), 1145(4)(a).

358 ss 783(2)(c), 784(2)(c), 1144A(2)(d), 1145(2)(e).

359 These criteria are based on those proposed in the *ASC Good Advice Report* (November 1995) for securities advisers (at 56-57).

360 For instance, in the case of securities advisers, the ASC has recommended that licensees demonstrate competence by obtaining an industry qualification or by passing an examination: *ASC Good Advice Report* (November 1995) Proposal 3.4. See also ASX art 36(1)(c)(i) and

accreditation responsibilities to appropriate industry groups. The Financial System Inquiry supports this approach.[361] The exchanges could also apply additional standards in the business rules for particular classes of derivatives.

5.16 *Good fame and character.* The ASC should have no reason to believe that the applicant (or its responsible officers) is not of good fame and character.[362]

5.17 *Efficiency, honesty and fairness.* The ASC should have no reason to believe that the applicant will not perform the licence duties efficiently, honestly and fairly.[363] This criterion encompasses ethical standards.[364]

5.18 *Requirement for SRO membership.* The Advisory Committee considers that the ASC and industry organisations should play a co-regulatory role in regulating on-exchange derivatives brokers.[365] An SRO can establish and enforce appropriate standards and rules of conduct for brokers. This is more flexible than legislative prescription. The exchanges and any clearing houses could set and enforce appropriate minimum educational, experience and financial requirements for their members, with adequate mechanisms to supervise and enforce those standards.[366] Also, the exchanges could establish dispute resolution procedures,[367] administer compensation funds[368] and impose minimum capital standards on their members.

5.19 Applicants for a licence to act as a broker in on-exchange derivatives should be obliged to be members of the exchange (or other relevant SRO, if one is formed) or otherwise agree to be bound by the exchange's rules.[369] The ASC should be permitted to accept a foreign applicant's membership of an SRO in its home jurisdiction in satisfaction of this criterion. In exercising that discretion, the ASC should consider

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Business Rule Guidance Note 4/96 "Education Prerequisites for ASX Membership" (23 September 1996).

361 *Financial System Inquiry Final Report* Recommendation 14.

362 ss 783(2)(d), 784(4)(c), 1144A(2)(e), 1145(4)(c).

363 ss 783(2)(e), 784(2)(d), 784(4)(d), 1144A(2)(f), 1145(2)(f), 1145(4)(d).

364 *ASC Good Advice Report* (November 1995) at 58.

365 Currently, an applicant for a futures brokers licence must be a member of a futures organisation (being a futures exchange or futures association) (in practice, the SFE): ss 1144A(2)(c), 1145(2)(d), 1148(1)(a). Applicants for dealers licences need not be members of a securities exchange. However, securities dealers cannot transact on the ASX unless they are members of the ASX or have agreed to be bound by the rules of the ASX.

366 Currently, the ASX and SFE impose these standards on their various classes of members. The SFE has three categories of members (Floor Members, Associate Members and Local Members). In this Report, for ease of reference, all these persons are referred to as members (and references to relevant SFE business rules have been confined to those applicable to Floor Members). A specific example of educational and other requirements is ASX r 9.7.3, which applies to share ratio contracts.

367 SFE art 40, ASX arts 63-65.

368 The Corporations Law Part 8.6 obliges a futures organisation to maintain a fidelity fund. The futures organisation can require its members to make contributions to the fund. Compare Part 7.10 (the National Guarantee Fund). Under Part 7.10 Div 4, the NGF can impose levies on member organisations of a participating exchange where the fund is less than the minimum statutory amount.

369 SFE *OTC Submission*.

whether the rules for that overseas SRO provide at least equivalent regulatory protection for Australian clients of the applicant.

Exemptions from licensing as on-exchange brokers

5.20 *Fund managers.* Currently, fund managers who trade in futures contracts on behalf of their funds must hold a futures brokers licence in addition to a securities dealers licence, unless they trade through a futures broker and the total value of their trading in futures contracts does not exceed 15% of the total value of fund assets.[370] The apparent purpose of this requirement was to restrict futures trading by fund managers unless they had sufficient expertise to obtain a futures brokers licence.

5.21 The Advisory Committee has considered whether this restriction should be retained in its current form in the proposed financial markets licensing scheme for derivatives trading. It has considered several policy alternatives:

- that the 15% limit be retained, but be based on a value other than the face value of the contract.[371] The current valuation test considerably restricts the level of derivatives trading permitted by a fund manager who does not hold a futures brokers licence

- that fund managers be exempt from some requirements currently applicable to futures licensees (for instance, risk disclosure, contract notes, periodic statements, segregation of funds and obligations to contribute to the fidelity fund)

- that fund managers must, prior to trading in on-exchange derivatives, have their financial markets licences endorsed for derivatives, regardless of the value of their derivatives trading, or, conversely

- that fund managers need only have their financial markets licences endorsed for securities dealings, and be exempt from the requirements applicable to derivatives licensees, regardless of their level of trading in on-exchange derivatives

- that fund managers should be separately regulated under collective investments legislation, which may involve a separate category of financial markets licence employing different criteria from those applicable to financial markets brokers.

5.22 The Advisory Committee supports the final policy option. The current licensing requirements for fund managers were developed when it was less common for fund managers to use derivatives. Also, various submissions argued that the obligations of

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370 Part 8.3 and Corp Reg 8.3.02.

371 Currently, this calculation is based on the full face value of futures contracts: Corp Reg 8.3.02(2)(d)(v) provides that "the value of [a dealing in a futures contract], when added to the total value of any other futures contracts in which the [management company] is dealing at that time on behalf of the holders of those prescribed interests, does not exceed 15% of the total value of assets held by the trustee or representative under that deed".

brokers, generally, are not relevant to fund managers, who may be discouraged from properly hedging or diversifying their fund portfolio to protect the interests of their investors.[372] For instance, the requirements for fund managers to report to their investors are set out in the trust deed. To impose additional reporting requirements through the licensing system for brokers would increase administrative costs for no additional benefit. Likewise, to require fund managers to provide risk disclosure statements, client agreement forms and contract notes to fund investors, as required under the proposed licensing provisions for derivatives brokers, would serve no purpose. The fund manager, not the investors, makes the derivatives transactions decisions. Fund managers' liability to investors should be determined according to their fiduciary responsibilities in making overall investment decisions, and any obligations under collective investments legislation, not by reference to broker licensing criteria.

5.23 *Trustee corporations.* One submission has questioned whether trustee corporations of managed funds are caught by the licensing requirements when they enter into transactions in other jurisdictions under the approved deed.[373] The Advisory Committee agrees that it would be inappropriate to require trustee corporations to be licensed.

5.24 *Treasury operations.* The Advisory Committee considers that intra-corporate treasury operations should be exempt from the licensing requirements. Submissions agreed.[374]

5.25 *Other exemptions.* The other exemptions from the current licensing requirements should remain.[375]

Prudential regulation of on-exchange brokers

5.26 The current SFE and ASX business rules require that on-exchange brokers act as principals in all transactions into which they enter on-exchange, whether or not on behalf of their clients. In consequence, the exchanges have developed prudential controls in the form of risk management and capital requirements for these brokers. These controls should be applied by financial exchanges, as discussed in Chapter 6 of this Final Report.[376]

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372 AIMA *On-exchange Submission* and *OTC Submission*, IFA *OTC Submission*, NMFM *OTC Submission*, ANZ *OTC Submission*, IBSA *OTC Submission*, Phillips Fox *OTC Submission*, AARF *OTC Submission*.

373 The Cornwall Stodart *On-exchange Submission* pointed out that a trustee will not have the benefit of the exemption in Corp Reg 8.3.02(2)(a) as the dealing is executed on behalf of the prescribed trustee corporation by an overseas broker, rather than the holder of a futures brokers licence under the Corporations Law (as required by subparagraph (ii)).

374 ASCT *OTC Submission* and *On-exchange Submission*, AFMA *OTC Submission*, Phillips Fox *OTC Submission*.

375 ss 67, 71, Corp Reg 8.3.02.

376 paras 6.8, 6.24, post.

Statutory obligations of on-exchange brokers

5.27 This Report elsewhere recommends that on-exchange derivatives brokers should be subject to statutory obligations regarding:

- risk disclosure[377]
- acting as counterparties to their clients[378]
- periodic statements[379]
- separation of client funds and property[380]
- record-keeping of clients' transactions[381]
- records of own trading[382]
- suitability obligations for discretionary accounts[383]
- cold calling retail clients.[384]

On-exchange derivatives advisers

Separating broking and advising functions

5.28 The functions of on-exchange broking and advising should be clearly differentiated, given the different knowledge and skills required for these activities. Persons who seek to be licensed as on-exchange derivatives brokers should nevertheless be required to have their financial markets licences separately endorsed to act as on-exchange derivatives advisers as well (or vice versa). This approach of separating the broking and advising functions would be preferable to the current law which provides that holders of brokers licences can automatically act as advisers and, in some circumstances, requires a person who gives advice to hold a dealers licence, rather than an advisers licence.[385]

Who should be licensed

5.29 Currently, futures and securities advisers must be licensed to carry on, or hold out that they carry on, an advice business.[386] The Advisory Committee favours

377 Recommendation 29.
378 Recommendation 32.
379 Recommendation 35.
380 Recommendations 36 and 39.
381 Recommendation 40.
382 Recommendation 41.
383 Recommendation 43.
384 Recommendation 45.
385 A person who gives advice to induce other persons to enter into securities transactions must hold a dealers licence, rather than an advisers licence: ASC Policy Statement 116.30-36, applying the s 93 definition of "securities business" and the s 9 definition of "deal".
386 ss 781, 1143. See also ss 71 (futures advice business), 77 (investment advice business). ASC Policy Statement 116:
- discusses the range of activity that constitutes securities advice (paras 15-19)
- sets out the tests for conducting a securities advice business (paras 23-28)
- identifies what activities do not amount to giving securities advice (para 29).

applying the same requirements to derivatives advisers. These requirements do not extend to the provision of purely factual information.[387]

5.30 The ASC has set out detailed guidelines on when persons must be licensed as advisers to provide securities investment advice through the media, in computer software and books, and on the Internet.[388] The same principles should apply to persons providing derivatives advice in these ways. The Advisory Committee also supports, in the derivatives context, the ASC's proposal that those media advisers who may operate without a licence should nevertheless be obliged to include in their publications appropriate warnings about the limitations of their general advice.[389]

5.31 *Incidental advice.* Currently, solicitors and accountants in public practice need not be licensed where they merely give incidental futures or other financial market investment advice.[390] The ASC considers that this exemption will apply to these persons only if:

- the advice forms an integral and merely incidental part of their overall services. This means that the advice is neither provided nor held out as a discrete service by the solicitor or the accountant
- they charge no discrete fee for the advice, and
- they do not receive any commissions or other benefits from product issuers.[391]

5.32 The same principles should apply to solicitors or accountants giving derivatives advice. The Financial System Inquiry also supported this incidental advice exemption.[392]

5.33 The ASC has proposed that the incidental advice exemption only apply to solicitors and accountants belonging to a recognised professional body that has appropriate standards of competence and conduct.[393] The Advisory Committee supports this additional element for the incidental derivatives advice exemption.

5.34 The Advisory Committee notes that any exemption will not overcome the general duty of care these professionals have when providing incidental advice.

- describes the circumstances in which a person who advises in securities needs to have a dealers, rather than an advisers, licence (paras 30-36).

387 ASC Policy Statement 116.20-22.

388 ASC Policy Statement 118. This Policy Statement applies to investment advice business, as defined in s 77. Compare s 71 (futures advice business).

389 ASC Policy Statement 118.20-21. See the form of wording suggested for inclusion in the Advisory Services Guide in ASX Business Rule Guidance Note 6/96 "Advisory Services Guide - Execution Related Telephone Advice" (30 September 1996) at 3-4.

390 ss 71(4), 77(5).

391 ASC Policy Statement 119.8-12.

392 *Financial System Inquiry Final Report* Recommendation 17.

393 ASC Policy Statement 119.13.

5.35 *Mere referrals.* The ASC exempts from the licensing requirements persons making mere referrals to licensees.[394] A mere referral is made when a person:

- does nothing more than merely introduce a potential client to a licensee, and
- does this merely as an incidental part of the person's other business.[395]

5.36 However, the licensee to whom the referrals are made must disclose details of any fees, commissions or other benefits payable to the referring party.[396] The Advisory Committee considers that the same principles should apply to mere referrals to derivatives licensees.

Preserving rights of existing on-exchange advisers

5.37 The Advisory Committee proposes that existing futures and securities advisers may continue to advise on those on-exchange derivatives products for which they are authorised at the time of enactment of the amending legislation. They would not need to obtain a new financial markets licence.

Criteria for approving new on-exchange advisers

5.38 The core financial markets licensing criteria for on-exchange advisers should generally be the same as for on-exchange brokers, namely:

- solvency
- educational qualifications and experience
- good fame and character
- efficiency, honesty and fairness.[397]

5.39 However, unlike the licensing criteria for on-exchange brokers, there should be no requirement that on-exchange advisers be members of an SRO.

No prudential regulation of on-exchange advisers

5.40 On-exchange advisers should not be subject to the same prudential requirements as on-exchange brokers, given that their advising function does not involve them acting as principals in on-exchange transactions.

Statutory obligations of on-exchange advisers

5.41 This Report elsewhere recommends that on-exchange derivatives advisers should be subject to statutory obligations in dealing with their retail clients regarding:

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394 ASC Policy Statement 120.

395 ASC Policy Statement 120.15.

396 ASC Policy Statement 120.30.

397 The criteria are based on those for futures and securities licensees: ss 783, 784, 1144A, 1145. The Financial System Inquiry also recommended minimum standards of competence and ethical behaviour for advisers: *Financial System Inquiry Final Report* Recommendation 15.

- client agreements[398]
- risk disclosure[399]
- personal recommendations[400]
- benefits disclosure[401]
- cold calling.[402]

5.42 In addition, the risk disclosure requirement should also apply to those wholesale clients who have not waived their rights.[403]

OTC

Purposes of OTC derivatives licensing

5.43 The Advisory Committee considers that the regulatory purposes of any licensing regime for the Australian OTC derivatives market are:

- *market stability*, that is, maintaining the stability of the market by prudentially regulating those participants who could most harm the market if they became insolvent. The Advisory Committee agrees with, and applies to the OTC derivatives market, the Financial System Inquiry's general observation that: "For market efficiency reasons, regulation must also take account of the risk that some financial failures may have onerous consequences for financial system stability and hence the real economy"[404]

- *end-user protection*, that is, regulating the conduct of intermediaries towards their clients

- *external surveillance*, that is, enabling the ASC to exercise surveillance over the activities of OTC licensees and, through the imposition of notification conditions on licensees, to otherwise monitor their conduct.

Policy options for OTC derivatives licensing

5.44 Currently, there is no licensing for the OTC derivatives market. The OTC DP proposed a regime of licensing for three categories of intermediaries in that market, namely brokers, advisers and market-makers. Submissions took differing views on the extent to which it was necessary to license these, or other, persons. The policy options, as reflected in the submissions, are:

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398 Recommendation 28.
399 Recommendation 29.
400 Recommendation 31.
401 Recommendation 33.
402 Recommendation 45.
403 Recommendation 29.
404 *Financial System Inquiry Final Report* at 182.

- *no licensing* - there should be no licensing in either the wholesale or the retail OTC market
- *licensing retail intermediaries only* - licensing should be confined to intermediaries in the retail OTC market
- *licensing intermediaries in both markets* - intermediaries in both wholesale and retail OTC markets should be licensed. These intermediaries could be classified as brokers, market-makers in the wholesale and retail markets, and advisers, or
- *licensing intermediaries in both wholesale and retail markets and other wholesale participants* - there should be licensing of principals as well as intermediaries in the wholesale OTC market and intermediaries in the retail OTC market.

No licensing

5.45 Several respondents opposed any mandatory licensing.[405] They argued that market forces and voluntary codes of conduct already provide a satisfactory substitute for licensing. This private regulation would continue to ensure that intermediaries are well capitalised and practise adequate risk management. The respondents also pointed to the administrative costs of introducing a licensing regime.

Licensing retail intermediaries only

5.46 Some submissions proposed that licensing should apply only to persons who act as intermediaries in the retail OTC derivatives market.[406] They argued that licensing in the wholesale market was unnecessary, as many of those participants were already subject to prudential requirements. Also, participants in the wholesale market are protected under the common law (for instance, remedies for misrepresentation or misstatements).[407]

Licensing intermediaries in both markets

5.47 Under this approach, the licensing goals of market stability and end-user protection could be achieved by licensing all OTC derivatives market intermediaries, including those who are in the business of acting as counterparties (market-makers). Failure of a significant number of these intermediaries could destabilise the market, given their strategic position in that market.

Licensing intermediaries in both markets and other wholesale participants

5.48 One submission[408] said that all persons who carry on a derivatives business in the OTC derivatives market, whether as principal or intermediary, should be licensed. The proposal to confine licensing to "intermediaries" entails definitional problems as

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405 For instance, ISDA *OTC Submission*, SIA *OTC Submission*, JP Morgan *OTC Submission*.

406 For instance, IBSA *OTC Submission*, Securities Industry Association *OTC Submission*, ASCT *OTC Submission*.

407 IBSA *OTC Submission*.

408 Phillips Fox *OTC Submission*.

to the terms "market maker" and "broker", and the distinction between these persons and end-users. This could increase uncertainty and compliance costs.

5.49 Another respondent submitted that the notion of market-makers may not fully take into account the way transactions are entered into on the OTC market.[409] It may be difficult to apply an intermediary-based licensing requirement to participants who are primarily end-users and who might only incidentally act as market-makers.

5.50 The Financial System Inquiry recommended that the licensing system should cover dealers and advisers and, in addition, financial market participants, meaning organisations dealing in investment products as principals, except where all dealings are conducted through a licensed person.[410]

Advisory Committee view

5.51 Given the purposes of licensing as identified above,[411] the Advisory Committee does not support the policy options of either no licensing or licensing only retail intermediaries. Conversely, the Advisory Committee considers that requiring all wholesale participants to be licensed could be over-regulatory and impose onerous prudential supervisory responsibilities on the regulator. It may also discourage overseas participation in the Australian OTC derivatives market.

5.52 The Advisory Committee supports the option of licensing intermediaries in wholesale and retail markets. It recognises that this policy could cause difficulty in clearly distinguishing between mere end-users and persons required to be licensed as market-makers. The ASC also recognises this problem.[412] The ASC should have a power to grant licensing exemptions for parties who are predominantly end-users, even if their activities might sometimes constitute market-making.

Positive or negative OTC licensing

5.53 The Advisory Committee has considered the relative merits of a positive or negative licensing regime for OTC intermediaries.

5.54 A positive regime would prohibit persons other than licensees from acting as intermediaries. It would be comparable to the current regime for securities and futures licensees. A negative licensing regime would permit any person to act as an OTC intermediary unless prohibited by the ASC or the court. It would be similar to the current regulation of company directors and the proposed regulation of persons conducting a business of own account dealings in on-exchange derivatives.[413]

5.55 The Advisory Committee considers that a positive licensing regime for the OTC derivatives market is necessary to better protect retail and other clients of

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409 AFMA *OTC Submission*.

410 FSI Report at 273 and Recommendation 13.

411 para 5.43, supra.

412 ASC *OTC Submission*.

413 para 5.7-5.10.

intermediaries. It may also guard against possible market abuses.[414] It agrees with the ASC recommendation to the same effect.[415] Positive licensing may prevent inappropriate persons from acting as intermediaries by imposing appropriate threshold standards. The ASC may also include conditions in licences to assist it in monitoring and disciplining licensees.[416] These controls would not be available under negative licensing.

Separate licence endorsement for each OTC function

5.56 A positive licensing regime should apply to brokers, market-makers and advisers in the OTC derivatives market. Separate licensing criteria would apply to each of these functions. In consequence, persons who wish to undertake more than one of these functions would need to have their financial markets licences separately endorsed for each desired function.

OTC derivatives brokers

Who should be licensed

5.57 Persons should be prohibited from carrying on a business, or holding out that they carry on a business, in Australia,[417] of dealing in any OTC derivatives contract[418] on behalf of another person (the client) or arranging for one person to enter into an OTC derivatives contracts with another person, unless they have a financial markets licence endorsed for acting as a broker in the OTC derivatives market.

Criteria for approving OTC brokers

5.58 The licensing criteria for OTC brokers should generally be the same as for on-exchange brokers, namely:

- solvency
- educational qualifications and experience (developed by the ASC in consultation with industry bodies)
- good fame and character
- efficiency, honesty and fairness.[419]

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414 These abuses could include "bucketshop" activities, that is, intermediaries not placing orders as instructed.

415 The *ASC OTC Report* paras 245-247 proposed a general obligation for derivative market intermediaries to be licensed.

416 For instance, a licence may be granted subject to a condition that the licensee provide full access to the ASC to monitor compliance with the terms of the licence. This would be additional to the statutory requirement that licensees immediately notify the ASC of any breaches of the terms of their licence and provide information to the Commission: cf ss 787, 788, 1153, 1154.

417 The notion of carrying on business in Australia is found in Part 1.2 Div 3 of the Corporations Law. However, the exemption in s 21(3)(e) (namely, soliciting or procuring an order that becomes a binding contract only if the order is accepted outside Australia) should not apply to the OTC derivatives market, given that many OTC transactions are cross-border.

418 cf Part 1.2 Div 4.

419 paras 5.12-5.17, supra.

5.59 However, unlike licensing of on-exchange brokers, there should be no requirement that OTC brokers be members of an SRO.[420]

Exemptions from licensing as OTC brokers

5.60 The fund management, treasury operations, trustee corporation and other exemptions from on-exchange licensing should also apply to licensing of OTC brokers.[421]

No prudential regulation of OTC brokers

5.61 OTC brokers differ from on-exchange brokers in that only the latter act as principals when transacting on behalf of their clients. Also, the functions of OTC broking do not include acting as counterparties to clients. Therefore, OTC brokers should not be subject to the types of prudential controls that the Advisory Committee considers necessary for on-exchange brokers or OTC market-makers.

Statutory obligations of OTC brokers

5.62 This Report elsewhere recommends that OTC derivatives brokers should be subject to statutory obligations regarding:

- client agreements with retail clients[422]
- generic risk disclosure[423]
- contract notes[424]
- periodic statements[425]
- separation of client funds and property[426]
- record-keeping of clients' transactions[427]
- discretionary accounts[428]
- cold calling retail clients.[429]

OTC derivatives market-makers who deal with wholesale end-users

Who should be licensed

5.63 Persons should be prohibited from carrying on a business, or holding out that they carry on a business, in Australia,[430] of *both* structuring and entering, as principal,

420 Contrast paras 5.18-5.19, supra.
421 paras 5.20-5.25, supra.
422 Recommendation 28.
423 Recommendation 29.
424 Recommendation 34.
425 Recommendation 35.
426 Recommendations 38 and 39.
427 Recommendation 40.
428 Recommendations 42 and 43.
429 Recommendation 45.
430 The notion of carrying on business in Australia is found in Part 1.2 Div 3 of the Corporations Law. However, the exemption in s 21(3)(e) (namely, soliciting or procuring an order that

into either, or one, side of an OTC derivatives transaction with an arm's length wholesale counterparty unless they have a financial markets licence endorsed for so acting.

5.64 The Advisory Committee emphasises that this licensing requirement is intended to cover only persons who carry on a business of structuring OTC derivatives for their wholesale counterparties. It is intended to cover "sellers" of derivatives products, not persons who merely customise their OTC transactions as end-users. Overseas jurisdictions apply a comparable notion of market-maker.[431]

Criteria for approving these market-makers

5.65 The licensing criteria for these OTC market-makers should be confined to prudential controls, given that their financial and operational soundness is crucial to the stability of any OTC derivatives market in which they are involved.[432] These market-makers would not be subject to the licensing criteria for OTC brokers.

5.66 The prudential controls for these OTC market-makers would involve:

- risk management systems, and
- capital standards.[433]

5.67 These prudential elements are discussed in detail in Chapter 6 of this Final Report.

5.68 To avoid regulatory duplication, the following two categories of market-makers (exempt OTC market-makers) should be exempt from this licensing requirement:

- entities regulated by the RBA,[434] and
- any other market-maker (or class of market-maker) whose risk management system and capital standards are, to the satisfaction of the ASC,

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becomes a binding contract only if the order is accepted outside Australia) should not apply to the OTC derivatives market, given that many OTC transactions are cross-border.

431 The US Derivatives Policy Group defines a market-maker as "[any firm] primarily engaged in the business of holding itself out to unaffiliated counterparties as a professional intermediary willing to structure and enter into either side of an OTC transaction as principal".

432 Compare ASC Policy Statement 70 which imposes prudential controls on persons conducting exempt futures markets. The ASC considers that "the financial stability of a facility provider is a crucial factor in the stability of any market conducted by that provider" (para 46).

433 The IOSCO Technical Committee Report *Operational and Financial Risk Management Control Mechanisms for Over-the-Counter Derivatives Activities of Regulated Securities Firms* (July 1994) stated: "The Technical Committee also recognises that strong management controls are only one element of the management of financial exposures. In particular they are not a substitute for adequate capital".

434 Respondents supported this exemption: RBA *OTC Submission*, SFE *OTC Submission*, ABA *OTC Submission*, Treasury (formerly Attorney-General's Department) *OTC Submission*, ANZ *OTC Submission*, BT *OTC Submission*, BZW *OTC Submission*, Coopers & Lybrand *OTC Submission*, IBSA *OTC Submission*, Phillips Fox *OTC Submission*, AFMA *OTC Submission*, Securities Industry Association *OTC Submission*, Westpac *OTC Submission*, AARF *OTC Submission*.

appropriately supervised by another domestic or foreign regulator or SRO.[435]

5.69 The majority of existing OTC market-makers would be exempt OTC market-makers and could operate as these market-makers without the need for ASC licensing.[436] The opportunity for other entities (non-exempt OTC market-makers) to be licensed by application to the ASC opens up the market to a broader range of market-making entities.

5.70 The ASC should continue to have jurisdiction over the conduct of all OTC derivatives transactions, regardless of who the counterparties are. For instance, the Commission should be entitled to exercise its investigative, enforcement and supervisory disclosure powers against exempt as well as non-exempt OTC market-makers.[437] Likewise, all market-makers should be subject to the controls on marketing[438] and the offence provisions.[439]

5.71 Prudential controls would not guarantee against defaults by market-makers. However, these controls could contribute to market stability by providing a significant level of confidence that, in general, market-makers have the financial resources, and have implemented risk management practices, to honour their derivatives obligations. An optimal regulatory system would not necessarily prevent occasional institutional failures.

Exemptions from licensing as these market-makers

5.72 The fund management,[440] treasury operations, trustee corporation and other exemptions from on-exchange licensing should also apply to licensing of these market-makers.[441]

Statutory obligation on these market-makers

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435 JP Morgan *OTC Submission* argued that prudential requirements should be consistent with, and take into account, existing international practice.
The ASX Public Consultation Document *Capital Adequacy for Securities Dealers* (November 1996) proposes whole-portfolio risk based capital standards for ASX securities dealers, taking into account any trading they might do as principals in on-exchange or OTC derivatives. Subject to the final formulation and implementation of this capital adequacy rule, the ASC could exempt any ASX member who is seeking to be an OTC market-maker to wholesale end-users from the capital requirement. The ASC might also exempt these persons from the risk management requirement, subject to appropriate procedures and controls being implemented by the ASX concerning risk management systems: refer ASX Public Consultation Document at paras 6.283-6.329.

436 IBSA *On-exchange Submission*, BT *On-exchange Submission* pointed out that the majority of OTC participants in the Australian market are financial institutions that are already subject to prudential supervision.

437 Recommendation 48.

438 Recommendation 45.

439 Recommendation 46.

440 Fund managers who conduct cross trades between their clients' funds could technically be classified as market-makers.

441 paras 5.20-5.25, supra.

5.73 This Report elsewhere recommends that these market-makers, including exempt OTC market-makers, should be required to provide generic risk disclosures to those wholesale clients who have not waived their rights.[442] These market-makers should also be subject to a suitability obligation where they operate a discretionary account on behalf of a wholesale client.[443]

OTC derivatives market-makers who deal with retail end-users

Who should be licensed

5.74 Persons should be prohibited from carrying on a business, or holding out that they carry on a business, in Australia,[444] of *both* structuring and entering, as principal, into either, or one, side of an OTC transaction with an arm's length retail counterparty, unless they have a financial markets licence endorsed for so acting.[445]

5.75 The Advisory Committee emphasises that this licensing requirement is intended to cover only persons who carry on a business of structuring OTC derivatives for their retail counterparties. It is intended to cover "sellers" of derivatives products, not persons who merely customise their OTC transactions as end-users.

Criteria for approving these market-makers

5.76 Applicants should have to satisfy two general criteria:

- *prudential controls*, given that the financial and operational stability of market-makers is a crucial factor in any OTC derivatives market in which they are involved. These are discussed in Chapter 6 of this Final Report
- *competence and integrity requirements*, namely good fame and character and efficiency, honesty and fairness.[446]

5.77 Any entity that is an exempt OTC market-maker[447] would not have to satisfy the ASC that they meet the prudential requirements.

5.78 However, all these market-makers would have to satisfy the competence and integrity requirements. For instance, RBA-regulated entities should not be automatically licensed as market-makers to retail end-users, given that the RBA is concerned with the financial and operational stability of these entities, but does not impose or supervise integrity standards for their relationships with their clients.

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442 Recommendation 29.

443 Recommendation 43.

444 The notion of carrying on business in Australia is found in Part 1.2 Div 3 of the Corporations Law. However, the exemption in s 21(3)(e) (namely, soliciting or procuring an order that becomes a binding contract only if the order is accepted outside Australia) should not apply to the OTC derivatives market, given that many OTC transactions are cross-border.

445 The SFE *OTC Submission* supported this approach.

446 SFE *OTC Submission*.

447 paras 5.68-5.69, supra.

5.79 The competence and integrity requirements would permit the ASC to assess the suitability of applicants, and also to monitor their dealings with retail end-users. Given these controls, the Advisory Committee does not support limiting these market-makers to banks or other bodies of similar standing.[448]

Exemptions from licensing as these market-makers

5.80 The fund management, treasury operations, trustee corporation and other exemptions from on-exchange licensing should also apply to licensing of these market-makers.[449]

Statutory obligations on these market-makers

5.81 This Report elsewhere recommends that these market-makers should be subject to statutory obligations to their retail clients regarding:

- client agreements[450]
- generic risk disclosure[451]
- record-keeping[452]
- discretionary accounts[453]
- indication of any buy-back undertaking[454]
- cold calling.[455]

OTC derivatives advisers

Who should be licensed

5.82 Persons should be prohibited from carrying on a business, or holding out that they carry on a business, in Australia,[456] of advising on OTC derivatives transactions, unless they hold a financial markets licence endorsed for OTC derivatives advising. However, there should be exemption provisions for incidental advice and mere referrals, comparable to those for on-exchange derivatives advising.[457]

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448 The SFE *OTC Submission* proposed that only authorised banks (or other prudentially supervised bodies of similar standing) or members of an authorised self-regulatory association should be permitted to conduct a business of entering OTC derivative contracts with retail persons.

449 paras 5.20-5.25, supra.

450 Recommendation 28.

451 Recommendation 29.

452 Recommendation 40.

453 Recommendations 42 and 43.

454 Recommendation 44.

455 Recommendation 45.

456 The notion of carrying on business in Australia is found in Part 1.2 Div 3 of the Corporations Law. However, the exemption in s 21(3)(e) (namely, soliciting or procuring an order that becomes a binding contract only if the order is accepted outside Australia) should not apply to the OTC derivatives market, given that many OTC transactions are cross-border.

457 paras 5.31-5.36, supra.

Criteria for approving OTC advisers

5.83 The criteria for approving OTC advisers should be the same as for on-exchange advisers, namely:

- solvency
- educational qualifications and experience
- good fame and character
- efficiency, honesty and fairness.[458]

No prudential regulation of OTC advisers

5.84 OTC advisers should not be subject to the same prudential requirements as OTC market-makers, given that their advising function does not involve them acting as principals in OTC derivatives transactions.

Statutory obligations of OTC advisers

5.85 This Report elsewhere recommends that OTC derivatives advisers should be subject to statutory obligations in dealing with retail clients regarding:

- client agreements[459]
- generic risk disclosure[460]
- personal derivatives recommendations[461]
- benefits disclosure[462]
- cold calling.[463]

5.86 In addition, the risk disclosure requirement should also apply to those wholesale clients who have not waived their right.[464]

Controls over all on-exchange and OTC financial markets licensees

Licence conditions

5.87 The ASC should have a power to impose conditions on new or existing financial markets licences, subject to compliance with natural justice principles.[465] In the context of derivatives, these conditions could include the following.

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458 para 5.38, supra.
459 Recommendation 28.
460 Recommendation 29.
461 Recommendation 31.
462 Recommendation 33.
463 Recommendation 45.
464 Recommendation 29.
465 cf s 1200 (opportunity for hearing).

5.88 *Restrictions on activities.* The ASC might restrict licensees to dealing or advising in derivatives transactions of which they have the requisite knowledge and experience.

5.89 *Impartial advice.* The ASC could impose licensing conditions on on-exchange and OTC derivatives advisers regarding the use of descriptions such as "independent", "impartial" or "unbiased" advisory services. These controls should be similar to those currently applying to securities advisers.[466]

5.90 *Dispute resolution.* The ASC could require that on-exchange or OTC derivatives advisers who provide derivatives advice services to their retail clients must have appropriate procedures for handling complaints and resolving disputes, including mechanisms to properly record, assess and resolve these matters in an efficient and fair manner. These procedures should be similar to those currently applying to securities advisers.[467] On-exchange and OTC derivatives advisers could satisfy this condition by agreeing to comply with industry-based dispute resolution procedures approved by the ASC.[468]

5.91 The ASC could impose a similar dispute resolution requirement on OTC derivatives brokers, at least for their retail clients, and OTC derivatives market-makers dealing with retail end-users. However, it would be unnecessary to impose a separate dispute resolution condition on on-exchange derivatives brokers, given that exchanges have these procedures.[469]

5.92 *Advisory Services Guide.* The ASC could require on-exchange and OTC derivatives advisers to issue to their retail clients an Advisory Services Guide (ASG). Its purpose would be to give clear key information on the advisory services it offers. This information could include:

- details of the adviser and any representative
- the nature of the advisory service offered
- the method and extent of charges for that service, and
- the retail client's rights when obtaining the advisory service offered.

5.93 The adviser should give the ASG to a retail client at the earliest available opportunity before providing derivatives advice services. The ASC has a similar policy with respect to the provision of securities advice.[470] The Advisory Committee considers that in the derivatives context, retail clients should receive a comparable ASG from on-exchange and OTC derivatives advisers. The ASG would only have to be given once to each retail client.

466 ASC Policy Statement 116 Part IV.

467 ASC Policy Statement 121 Part VI.

468 See, for instance, *AFMA Manual* Section 6, Chapter 3, Alternative Dispute Resolution.

469 para 5.18, supra.

470 ASC Policy Statement 121 Part III. Where a client receives execution-related telephone advice, the adviser must provide the ASG to the client within three days after the trading following that advice: ASC Policy Statement 122.142. See also ASX Business Rule Guidance Note 6/96 "Advisory Services Guide - Execution Related Telephone Advice" (30 September 1996).

Accounting and other records

5.94 Financial markets licensees should be required to lodge with the ASC annual financial statements and other information similar to that currently required for futures licensees.[471] Licensees' accounts should be audited. Auditors and the courts should have appropriate powers to enforce the accounting obligations.[472]

Responsibility for representatives

5.95 Currently, futures and securities licensees are responsible for the conduct,[473] training and supervision of their representatives. The same principles should apply to all financial markets licensees and their representatives. Submissions to this review supported the principle that licensees be responsible for individuals who act on their behalf.[474] The Financial System Inquiry reached a similar conclusion.[475]

5.96 The ASC considers that a person who makes a "mere referral" to a securities licensee does not have to hold a proper authority from that licensee.[476] The same principles should apply to all financial markets licensees.

Disciplinary powers

5.97 The ASC should be entitled to suspend or revoke financial markets licences and impose banning orders, subject to the same procedures (including hearing rights) as currently apply to licensees.[477] The court should also have a disqualification power.[478]

On-exchange and OTC derivatives market licensing

Single licensing system

Recommendation 13. There should be a single financial markets licensing system.

On-exchange broking

Recommendation 14. Persons should be prohibited from carrying on a business, or holding out that they carry on a business, of dealing in any on-exchange derivatives contract on behalf of another person unless they hold a financial markets licence endorsed for on-exchange derivatives broking.

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471 ss 1157, 1158, 1218, Corp Regs Forms 802, 802A, 803A, 803B, 806, 807, 807A, 811, 812.

472 ss 1215-1227.

473 Part 7.3 Divs 3 and 4, ss 88, 94, Corp Reg 7.3.02, Part 8.3 Divs 3 and 4, ss 71, 73, 87, Corp Reg 8.3.03. These principles are further discussed in relation to securities licensees in ASC Policy Statement 117. See also ASX r 7.2.2.10.

474 For instance, ABA *OTC Submission*, Westpac *OTC Submission*.

475 The *Financial System Inquiry Final Report* at 273 stated that: "Licensees should be responsible for the competency and conduct of their employees and agents".

476 ASC Policy Statement 120. The tests of what constitutes a mere referral are set out in paras 15 ff.

477 Part 7.3 Div 5, Part 8.3 Div 5.

478 cf ss 1201, 1202.

On-exchange own account dealings

Recommendation 15. The ASC should have a power to ban persons who behave improperly from dealing on a financial exchange as principals on their own account.

On-exchange advising

Recommendation 16. Persons should be prohibited from advising on on-exchange derivatives, or holding out that they carry on a derivatives advice business unless they hold a financial markets licence endorsed for advising in derivatives.

Recommendation 17. Media advisers who are permitted to operate without a licence should be required to include in their publications appropriate warnings about the limitations of their general advice.

Recommendation 18. Solicitors and accountants in public practice who give merely incidental derivatives advice need not be licensed provided:

- the advice forms an integral and merely incidental part of their overall services
- they charge no discrete fee for the advice
- they do not receive any commissions or other benefits from product issuers, and
- they belong to a recognised professional body that has appropriate standards of competence and conduct.

Transitional

Recommendation 19. Existing futures and securities licensees should be permitted to continue to deal or advise in those on-exchange derivatives products for which they are authorised at the time of enactment of the amending legislation. They should not be required to obtain a new financial markets licence.

OTC broking

Recommendation 20. Persons should be prohibited from carrying on a business, or holding out that they carry on a business, in Australia, of:

- dealing in any OTC derivatives contract on behalf of another person, or
- arranging for one person to enter into an OTC derivatives contracts with another person

unless they have a financial markets licence endorsed for acting as a broker in the OTC derivatives market.

OTC market-makers to wholesale end-users

Recommendation 21. Persons should be prohibited from carrying on a business, or holding out that they carry on a business, in Australia, of structuring and entering, as principal, into either, or one, side of an OTC derivatives transaction with an arm's length wholesale counterparty unless they have a financial markets licence endorsed for so acting.

In determining whether to grant a financial markets licence endorsed for market-making in the wholesale derivatives market, the ASC should apply the following prudential criteria:

- risk management systems
- capital standards.

The following two classes of market-makers (exempt OTC market-makers) should be exempt from the licensing requirements:

- entities regulated by the RBA, and
- any other market-maker (or class of market-maker) whose risk management system and capital standards are, to the satisfaction of the ASC, appropriately supervised by another domestic or foreign regulator or SRO.

OTC market-makers to retail end-users

Recommendation 22. Persons should be prohibited from carrying on a business, or holding out that they carry on a business, in Australia, of structuring and entering, as principal, into either, or one, side of an OTC derivatives transaction with an arm's length retail counterparty, unless they have a financial markets licence endorsed for so acting.

In determining whether to grant a financial markets licence endorsed for market-making in the retail derivatives market, the ASC should apply competence and integrity as well as prudential criteria. Exempt OTC market-makers should not have to satisfy the ASC that they meet the prudential requirements.

ASC power to exempt OTC end-users from market-makers licensing

Recommendation 23. The ASC should have a power to exempt parties whose activities might sometimes constitute market-making, but who are predominantly end-users, from the OTC market-maker licensing provisions.

OTC advising

Recommendation 24. Persons should be prohibited from carrying on a business, or holding out that they carry on a business, of advising on OTC derivatives transactions, unless they hold a financial markets licence endorsed for OTC derivatives advising.

The principles relating to media advice and incidental advice by on-exchange advisers should also apply to OTC advisers.

On-exchange and OTC exemptions

Recommendation 25. There should be appropriate exemptions from the licensing provisions, including for fund managers, treasury operations and trustee corporations.

Chapter 6. Prudential regulation of on-exchange brokers and OTC market-makers

This Chapter deals with proposals to assist on-exchange brokers and OTC market-makers to manage their derivatives trading properly through risk management systems and capital requirements.

Nature of prudential regulation

6.1 The Advisory Committee proposes that all on-exchange derivatives brokers and non-exempt OTC market-makers[479] be subject to exchange or ASC prudential regulation covering:

- risk management systems, and
- capital requirements.

6.2 There is an increasing inter-connection between these requirements. Modern prudential regimes place as much emphasis on systems to monitor and control risk as on the maintenance of minimum capital requirements. A prudential regime that obliges an intermediary to maintain a level of capital calculated by reference to its risk-weighted portfolio, and to report regularly against that standard, effectively also requires that the intermediary at all times be able to value its portfolio, and measure the risks associated with it.[480] For instance, value at risk models, which may be used to calculate capital requirements, depend on obtaining accurate and timely information about an entity's investment portfolio and trading activities.[481] This can best be ensured through a properly functioning risk management system.

6.3 Prudential controls are a form of preventative regulation, designed to assist prudentially regulated entities to manage their derivatives trading properly. These controls, even at their most intensive, cannot constitute a regulatory assurance of the continuing financial soundness of each prudentially regulated entity. Also, they should not require the regulator to act as an underwriter of each entity. The Advisory Committee agrees with the Financial System Inquiry that: "Prudential regulation adds an extra layer of oversight beyond regulation of disclosure and conduct, but this should not constitute a guarantee".[482]

6.4 The Advisory Committee notes the recommendations by the Financial System Inquiry that it is not necessary at this time to impose additional prudential regulation on financial market licence holders. Rather, the regulatory agencies should monitor wholesale markets for the emergence of large institutions not subject to regulation domestically or overseas by a prudential regulator.[483] The Advisory Committee

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479 paras 5.68-5.69, supra.

480 ASC *OTC Submission*.

481 For an explanation of value at risk models, see paras 6.30-6.31, post.

482 *Financial System Inquiry Final Report* at 300.

483 *Financial System Inquiry Final Report* Recommendations 18, 58.

considers that there should be uniform prudential regulation of all key participants in the on-exchange and OTC derivatives market. The problem of possible duplicate prudential regulation of some market participants referred to by the Financial System Inquiry[484] is overcome by exempting particular categories of market-makers (exempt OTC market-makers).[485]

Risk management

6.5 Compared with other financial transactions and products, some derivatives products can be extremely complex and the risks associated with their use can develop very quickly. Overseas experience has indicated that market participants may be exposed to excessive financial risks from derivatives transactions if they have no risk limits or any risk limits are too permissive or too easily breached, if trading and settlement functions are not separated, or if their employees can engage in unauthorised trading without immediate detection.

6.6 Derivatives risk management systems are intended to limit, monitor and manage the risks to which an entity may be exposed through derivatives transactions by:

- requiring policies to determine derivative risk limits
- developing methods to measure these risks[486]
- introducing internal procedures and controls to implement, monitor and ensure compliance with these risk limits.[487]

6.7 Effective risk management does not mean eliminating all risk, but rather identifying and measuring risk accurately and consistently with an organisation's predetermined objectives and policies. If properly employed and widely used, risk management should:

- protect entities against excessive or unauthorised risk-taking or exposures to open positions in derivatives markets
- protect counterparties in the OTC market by reducing the possibility of entities defaulting on their obligations
- enhance general market stability
- increase market disclosure.[488]

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484 *Financial System Inquiry Final Report* at 276.

485 para 5.68, supra.

486 Value at risk models are one method of measuring the market risk element of OTC derivatives risks: see further paras 6.30-6.33, post.

487 Various risk management models are found in the G-30 Report (July 1993), the Joint Statement of the US Securities and Exchange Commission, the US Commodity Futures Trading Commission and the UK Securities and Investments Board on *OTC Derivatives Oversight* (March 1994), the United States General Accounting Office (GAO) *Report* (May 1994), the Basle Committee Report *Risk Management Guidelines for Derivatives* (July 1994), Part II of the IOSCO Technical Committee Report *Operational and Financial Risk Management Control Mechanisms for Over-the-Counter Derivatives Activities of Regulated Securities Firms* (July 1994), the United States Office of the Comptroller of the Currency *Risk Management of Financial Derivatives Handbook* (October 1994) and the US Derivatives Policy Group Paper *Framework for Voluntary Oversight* Chapter II (March 1995).

On-exchange

6.8 Currently, there are no statutory risk management obligations for on-exchange dealers or brokers. However, clearing house requirements, particularly daily marking-to-market and margining, are designed to alert on-exchange dealers to their true financial position (and that of their clients) and ensure that they can honour their immediate obligations. Also, SFE and ASX exchange and clearing house business rules require members to maintain adequate internal arrangements to perform their functions (for instance, separating their settlement and trading functions).[489] The exchanges require that their members' internal control procedures be audited.[490] The ASX has developed proposals to introduce more detailed risk management methods.[491] The Advisory Committee supports financial exchanges having this regulatory role.

OTC

Mandatory or voluntary risk management

6.9 Currently, there are no specific statutory risk management obligations for participants in the OTC derivatives market. However, the Reserve Bank requires banks to have risk management systems (though these are not designed specifically for OTC derivatives trading). Also, directors and managers of corporate OTC market participants who fail to adopt an adequate internal risk management system in using derivatives may breach their common law and statutory duties to their companies.[492]

6.10 The Advisory Committee has considered whether risk management should be a matter for external supervision or be left to market forces. There have been several industry initiatives. In 1994, JP Morgan released its proprietary risk management

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488 The Working Group of the Eurocurrency Standing Committee of the Central Banks of the Group of Ten Countries *Public Disclosure of Market and Credit Risks by Financial Intermediaries* (September 1994) stated: "If firms with superior risk management systems begin to disclose information adapted from these systems, this process could institute a dynamic competitive process leading to enhanced disclosure practices and greater market transparency" (at 6).

489 See, for instance, SFECH By-laws 4.4(e), 4.8 and ASX r 10.2.1.3(c). This is consistent with the *Futures Industry Association Financial Integrity Recommendations* (June 1995) Recommendation 45 that brokers should establish general risk management guidelines and procedures for their proprietary trading, to be monitored regularly by independent persons.

490 SFE art 3.6(3)(b)(iv) and Eighth Schedule to SFE Articles and By-laws, ASX r 1.3(10). This is consistent with international best practice: *Futures Industry Association Financial Integrity Recommendations* (June 1995) Recommendation 16.

491 The ASX Public Consultation Document *Capital Adequacy for Securities Dealers* (November 1996) at paras 6.290-6.329 proposes the possible future use of internal risk management models by ASX dealers. Their use would depend on the ASX being satisfied that certain qualitative and quantitative standards, and model integrity criteria, have been satisfied.

492 *Daniels v AWA Limited* (1995) 16 ACSR 607; s 232(4) (duty of care and diligence). This common law or statutory breach may arise, for instance, through their failure to investigate and understand the risks associated with derivatives trading by their companies, or if they delegate responsibility entirely to the trading division without due supervision or separation of trading and settlement functions. They also have a continuing obligation to keep informed about the derivatives activities of their companies.

model, RiskMetrics. In 1995, the Futures and Options Association published a voluntary code to deal with:

- formulating a policy for the use of derivatives
- supervision of the risk management process by senior management
- the measurement, control and reporting of risk exposures, and
- internal controls and audits.[493]

6.11 Notwithstanding these initiatives, regulators have generally taken the view that market forces do not suffice to ensure that key industry participants have adequate risk management systems. For instance, IOSCO has argued that adequate managerial and financial risk management control mechanisms cannot be left solely to the influence of market forces. Both the Basle Committee[494] and IOSCO[495] have issued detailed risk management guidelines aimed at market intermediaries. More recently, the UK Investment Management Regulatory Organisation (IMRO) has proposed that all firms introduce internal systems and controls to ensure effective risk management.[496]

Risk management for market-makers

6.12 The OTC market could be seriously destabilised by the financial failure of one or more large OTC market makers. This problem has been recognised in overseas markets, with proposals to extend prudential regulation to entities other than banks.[497] Market makers who lack effective risk management systems may be at a greater risk of financial failure.[498] The Advisory Committee therefore recommends that all non-exempt OTC market-makers[499] should be required to satisfy the ASC that they have a minimum satisfactory risk management system for their derivatives transactions, albeit that this may be part of an overall risk management system for all their financial activities. Many submissions supported this proposal.[500]

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493 Futures and Options Association, *Managing Derivatives Risk: Guidelines for End-users of Derivatives* (December 1995).

494 Basle Committee, *Risk Management Guidelines for Derivatives* (July 1994).

495 IOSCO Technical Committee Report *Operational and Financial Risk Management Control Mechanisms for Over-the-Counter Derivatives Activities of Regulated Securities Firms (*July 1994).

496 IMRO Consultation Document 33 *Derivatives* (November 1996). Appendix 2.1(2) to that document sets out guidelines which firms should consider in determining whether their systems and controls are adequate for the proper conduct of their permitted businesses where these include the use of derivatives.

497 M Taylor, "Financial Regulation in the UK: A Structure for the 21st Century" (1996) vol III, Issue 2, *The Futures and Derivatives Law Review*, 7 at 8.

498 The ASC has observed, in ASC Policy Statement 70 para 38, that: "The stability of individual facility providers [market makers] is enhanced if there is a mechanism which obliges facility providers to monitor internally risks associated with over-the-counter futures market transactions and to report them externally."

499 paras 5.68-5.69, supra.

500 For instance, Phillips Fox *OTC Submission*, RBA *OTC Submission*, Westpac *OTC Submission*, Treasury (formerly Attorney-General's Department) *OTC Submission*, AARF *OTC Submission*, John O'Sullivan *OTC Submission*.

6.13 It would be unsatisfactory for either the legislation or the ASC to mandate any specific risk management arrangements, given that risk management systems are constantly developing and need to be sufficiently adaptable to suit different types of businesses. Existing systems may also need to be modified over time, depending on changes in the size, nature and activities of a business and the types and complexity of particular derivatives entered into.[501] The ASC could publish guidelines or information papers on the impact of new forms of derivatives products on risk management and capital standards.[502]

6.14 In applying to the ASC for an OTC market-makers licence, all non-exempt OTC market-makers should:

- summarise the elements of their proposed risk management system
- undertake that their system satisfies minimum risk management standards[503]
- undertake that they will implement the system as described.

6.15 In assessing these matters, the ASC could have a confined role, comparable to the method proposed for it to assess collective investment scheme compliance plans.[504] That assessment should have regard to current industry practice.[505] Also, continued implementation of a minimum satisfactory risk management system should be a condition of any licence to act as a market maker. The ASC should have the power to conduct surveillance to verify that the risk management systems exist and operate in the way described by non-exempt OTC market-makers. The ASC should have the power to suspend, or if necessary revoke, a licence if it considers that the licensee has breached that condition.[506]

6.16 Requiring OTC market-makers to devise their own risk management systems also strengthens the market orientation of regulation, rather than placing undue reliance on external controls.

501 ABA *OTC Submission*, IBSA *OTC Submission*, ISDA *OTC Submission*, JP Morgan *OTC Submission*, AFMA *OTC Submission*, BT *OTC Submission*.

502 In the USA, for instance, the Federal Reserve and the OCC in 1996 published new guidelines on credit derivatives, and the monitoring of the particular risks arising from their use.

503 For instance, the Hong Kong Securities and Futures Commission requires that all OTC intermediaries implement risk management systems which are at least as stringent as guidelines based on the IOSCO Technical Committee Report *Operational and Financial Risk Management Control Mechanisms for Over-the-Counter Derivatives Activities of Regulated Securities Firms* (July 1994).

504 ALRC/CASAC Report, *Collective Investments: Other People's Money* (1993) vol 1 Chapter 9 and paras 10.35-10.44, as also reflected in the draft Collective Investments Bill (December 1995).

505 See, for instance, *AFMA Manual* Section 6 Chapter 1: Risk Management. Compare the proposed role of the ASX in assessing the risk management methods of exchange dealers: ASX Public Consultation Document *Capital Adequacy for Securities Dealers* (November 1996), paras 6.290-6.329.

506 This suspension or revocation power should be subject to natural justice hearing rights: cf ss 1191, 1192, 1200.

6.17 Another benefit in obliging these market-makers to design their risk management systems is to emphasise that risk management is a corporate governance issue.[507] The Advisory Committee considers that directors and managers should bear day-to-day responsibility for the prudent operation of their enterprises.[508] The RBA and the ISC take this approach in their role as prudential regulators. Likewise, the Financial System Inquiry observed that "the primary responsibility for prudential behaviour rests with the board and management of a financial institution".[509] Also, the possibility that exposures can change very quickly would militate against reliance on external regulation or periodic accounting disclosures as effective substitutes for ongoing internal supervision.

6.18 All non-exempt OTC market-makers should be required to confirm in each annual report that they have an effective risk management system for the types of derivatives they transact. This would reinforce the ultimate responsibility of directors for managing the risks undertaken by their entities and the adequacy of their systems for monitoring those risks. The alternative policy of requiring auditors to provide annual audit certificates concerning the operation of the risk management system could unduly displace responsibility onto the auditor.[510]

6.19 The Advisory Committee has considered whether non-exempt OTC market-makers should be required to describe their risk management system in each annual report. The Advisory Committee notes that AASB 1033/AAS 33 and the Australian Society of Corporate Treasurers (ASCT) Industry Statement (March 1995) encourage this disclosure. Also, disclosure of risk management information could help the market to assess counterparty credit risk. However, the Advisory Committee is concerned that any mandatory disclosure requirement in annual reports:

- may be unduly onerous or uncertain in its application, given the complex variety of elements which may make up a risk management system and which may differ considerably between entities. These differences may also make any comparative analysis misleading or meaningless
- may result in OTC participants having to make public what would otherwise be confidential information about their commercial operations
- may be misleading in some circumstances, as risk management systems may rapidly change in response to new products or risk management methods.

6.20 Given these possible consequences, the Advisory Committee does not support this annual report requirement. Submissions generally agreed.[511]

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507 ABA *OTC Submission*, IBSA *OTC Submission*.

508 The directors of corporate end-users may be obliged to implement and supervise internal risk management systems as part of their duties as directors: *Daniels v AWA Ltd* (1995) 16 ACSR 607.

509 *Financial System Inquiry Final Report* at 335.

510 However, audit certificates are currently required under the RBA rules.

511 ABA *OTC Submission*, Treasury (formerly Attorney-General's Department) *OTC Submission*, Phillips Fox *OTC Submission*, RBA *OTC Submission*, Westpac *OTC Submission*, AFMA *OTC Submission*, ASCT *OTC Submission*, AARF *OTC Submission*, John O'Sullivan *OTC Submission*, SFE *OTC Submission*.

Risk management for wholesale end-users

6.21 The Advisory Committee in the OTC DP raised the issue whether all wholesale participants, not just market-makers, should be obliged to have a risk management system for their OTC derivatives transactions. Some submissions supported this requirement as a matter of good corporate governance.[512] However, most respondents opposed any mandatory risk management requirement.[513] They argued that:

- it would arbitrarily single out derivative contracts as the only type of financial market instrument subject to mandatory risk management
- for listed companies, the continuous disclosure requirements and corporate governance principles in the ASX Listing Rules may suffice[514]
- similar requirements are not found in any other jurisdiction
- the Corporations Law obligations on directors and other officers of a company to exercise care and diligence in the discharge of their duties in effect require wholesale end-users to adopt appropriate systems for monitoring and managing derivatives risk.

6.22 Taking these submissions into account, the Advisory Committee does not propose that wholesale end-users be obliged to have a risk management system for their OTC derivatives transactions.

6.23 Those wholesale end-users who choose to employ a risk management system should not be required to disclose the details of those systems, for the same reasons as for OTC market-makers.

Prudential regulation: risk management

Recommendation 26. OTC market-makers (other than RBA-regulated entities and other exempt OTC market-makers) should be required to satisfy the ASC that they have a minimum satisfactory risk management system for their derivatives transactions.

The ASC should have the power to conduct surveillance to verify that the risk management systems exist and operate in the way described by these market-makers.

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512 ANZ *OTC Submission*, Treasury (formerly Attorney-General's Department) *OTC Submission*, AARF *OTC Submission*. The G30 *Global Derivatives Report* July 1993 proposed that end-users as well as dealers implement risk management systems.

513 IBSA *OTC Submission*, ISDA *OTC Submission*, NMFM *OTC Submission*, Phillips Fox *OTC Submission*, RBA *OTC Submission*, AFMA *OTC Submission*, Westpac *OTC Submission*, ASCT *OTC Submission*, John O'Sullivan *OTC Submission*, SFE *OTC Submission*, BT *OTC Submission*.

514 ASX Listing Rule 4.10.3 requires a listed entity to disclose in its annual report a "statement of the main corporate governance practices that the entity had in place during the reporting period". Appendix 4A sets out a list of corporate governance matters that an entity may take into account in complying with this requirement. These matters may include a statement of "The governing body's approach to identifying areas of significant business risk, and to putting arrangements in place to manage them" (cl 8).

The ASC should have the power to suspend, or if necessary revoke, the licence of any of these market-makers if it considers that the licensee no longer has a satisfactory risk management system.

These market-makers should be required to confirm in each annual report that they have an effective risk management system for the types of derivatives they transact.

Capital requirements

On-exchange

6.24 The Advisory Committee considers that clearing members should be subject to minimum capital requirements set by the exchange or clearing house to deal with the financial risks of their own derivatives trading, and the possible defaults of their clients, given that they act as principals in all on-exchange trading. This approach of measuring capital adequacy based on risk is reflected, for instance, in recent ASX initiatives concerning capital adequacy for ASX securities dealers.[515]

OTC

6.25 The Advisory Committee in its OTC DP proposed that market-makers be subject to minimum capital requirements. The Committee recognised that any capital requirement could not cover all possible losses that a participant in the OTC derivatives market might incur from its OTC trading. This would require participants to quarantine very substantial capital or to hold substantial net tangible assets. It would also act as a barrier to becoming a market-maker. Rather a capital requirement could:

- impose a financial commitment on market-makers ("hurt money")
- provide a limited pool of funds for counterparties ("comfort money") and thereby reduce the possibility of "roll-on" losses which may endanger the stability of other entities and the market generally
- impose a ceiling on the amount of risk that a market-maker could lawfully assume if the capital requirement is linked to value at risk, and
- provide funds to permit an intermediary to liquidate its business without disrupting the orderly functioning of financial markets.[516]

6.26 The ability to meet capital standards may also be some evidence of capacity to operate in the market ("skill money").

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515 See ASX Public Consultation Document *Capital Adequacy for Securities Dealers* (November 1996). Under the ASC/ASX *Memorandum of Understanding on Membership Matters* (November 1993), the parties agreed that the ASX "will continue to undertake primary responsibility for ensuring that ASX members are financially sound".

516 There is a UK precedent for a similar requirement. A UK investment firm must maintain in cash, or assets easily convertible into cash, financial resources in excess of its "financial resources requirement". This requirement takes into account the nature of the firm's operations and its current investments. See further *CASAC Research Paper* at 82. The notion of value at risk is further explained at para 6.30, post.

6.27 Submissions generally supported some capital requirement in the OTC market.[517] The debate turned on who should be subject to that requirement, who should administer it, and how it should be formulated.

Who should be subject to the capital requirement

6.28 The Advisory Committee considers that the key purpose of capital requirements in the OTC derivatives context is to ensure that those participants who are in the business of acting as counterparties on their own behalf are required to maintain minimum capital to support their financial obligations in that market. For this reason, OTC market-makers should be subject to capital requirements. By contrast, OTC brokers, by definition, act on behalf of others who are responsible for the financial obligations incurred. It would be inappropriate to impose on brokers capital requirements that deal with, for instance, credit risk and market risk. Instead, OTC brokers should be subject to financial requirements comparable to those currently applicable to securities dealers.

Administration of the capital requirement

6.29 All non-exempt OTC market-makers[518] should be required to satisfy the ASC that they meet minimum capital standards applying to all their OTC derivatives trading activities. Also, continued compliance with those standards should be a condition of any licence to act as an OTC market-maker. The ASC could be assisted in its compliance surveillance role by imposing conditions on non-exempt OTC market-makers that require periodic review by external auditors of their capital requirements. The ASC should also have the power to suspend, or if necessary revoke, a market-makers licence if it considers that the licensee has breached the compliance condition.[519]

Formulation of the capital requirement

6.30 The ASC, in consultation with industry regulators or other groups, could develop appropriate capital standards for non-exempt OTC market-makers, that take into account, for instance, counterparty credit risk and market risk.[520] Where

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517 ANZ *OTC Submission*, Coopers & Lybrand *OTC Submission*, Treasury (formerly Attorney-General's Department) *OTC Submission*, Westpac *OTC Submission*, AFMA *OTC Submission*, ASC *OTC Submission*, AARF *OTC Submission*, SFE *OTC Submission*, John O'Sullivan *OTC Submission*, BT *OTC Submission*, Corrs *OTC Submission*, Phillips Fox *OTC Submission*.

518 paras 5.68-5.69, supra.

519 Exercise of this disciplinary power should be subject to natural justice hearing rights: cf ss 1191, 1192, 1200.

520 Many submissions argued that any capital requirement should cover both counterparty credit risk and market risk: Coopers & Lybrand *OTC Submission*, AFMA *OTC Submission*, Westpac *OTC Submission*, ANZ *OTC Submission*, ASC *OTC Submission*.
The ASC could utilise the approach currently being developed by the ASX in its Public Consultation Document *Capital Adequacy for Securities Dealers* (November 1996). That Document proposes that minimum capital requirements for ASX members be based on their activities (including transacting as principals in on-exchange or OTC derivatives) and the risks

appropriate, these capital standards could be risk-weighted capital requirements using an applicant's value at risk methods,[521] rather than a fixed minimum capital requirement. This approach is reflected in the Basle capital standards for banks (adopted in Australia) which allow the use of proprietary in-house models for measuring market risk (and therefore the necessary supporting capital) as an alternative to fixed minimum capital requirements.[522] The ASC could approve an entity using its own risk assessment model, and the capital requirements arising therefrom, if sufficiently informed about the elements of the model, its effectiveness, and the procedures for, and controls on, its use by the applicant.[523]

6.31 The Advisory Committee notes that value at risk assessments are based primarily on historical data and do not reflect current changes to the market. Also, value at risk assessments may not accommodate unusual or unexpected events, such as large adverse market movements, for which a capital requirement is most necessary. Consequently, there should be a "cushion" of required capital for regulatory purposes in excess of that determined by any value at risk model.[524]

6.32 Any method for determining capital requirements for non-exempt OTC market-makers should adopt a whole portfolio approach by taking into account an entity's overall financial activities (including equities and on-exchange and OTC derivatives transactions) and any relationships between them.[525] For instance, OTC

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associated with these activities. The Document proposes that the liquid capital of each ASX member must exceed the total risk requirement, determined by measuring, and combining, a member's operational risk (the minimum amount required to commence and remain in business as a dealer), position (market) risk and counterparty credit risk, as well as large exposure risk and underwriting risk, arising from financial transactions undertaken.

521 Value at risk models estimate potential loss due to possible adverse market movements over a prescribed time interval (for instance, one day) for a given confidence level (for instance, 95% or 99%). These models primarily deal with market risk (that is, the risk of adverse movements in the market value of the transaction). Value at risk models may differ depending on the assumptions made about likely market movements, the various factors that will affect those movements and the period that is examined in determining the possible effects of these factors. Value at risk models are based on the assumption that future price movements will reflect past price trends. They may differ depending on the chosen historical period on which the data are based and the statistical "confidence interval" adopted, that is, the percentage chance that actual market volatility will exceed past market movements.
The methodology for determining value at risk is outlined in detail in the US Derivatives Policy Group Paper *Framework for Voluntary Oversight* (March 1995) and the Basle Committee *Proposals to Issue a Supplement to the Basle Capital Accord to Cover Market Risks* (April 1995).
Examples of value at risk models include the Correlation Method, the Historical Simulation Method and the Monte Carlo Simulation Method: ASX Public Consultation Document *Capital Adequacy for Securities Dealers* (November 1996), at paras 6.293-6.303.

522 Basle *Amendment to the Capital Accord to Incorporate Market Risk* (January 1996); RBA *Capital Adequacy of Banks*: *Draft Prudential Statement No. C3* (August 1996).

523 The ASX Public Consultation Document *Capital Adequacy for Securities Dealers* (November 1996) at paras 6.288, 6.304-6.329 analyses these matters in detail.

524 For instance, the Basle Committee requires a multiplication factor of three to be applied to the value at risk calculation for determining the capital requirements for those banks permitted to use their own value at risk models.

525 SFE *OTC Submission*, IBSA *OTC Submission*, ISDA *OTC Submission*, RBA *OTC Submission*. The ASX Public Consultation Document *Capital Adequacy for Securities Dealers* (November 1996) adopts a whole portfolio approach. For instance, it proposes that the capital

and physical transactions may be linked for hedging purposes. Market risk could be overstated (and therefore the capital requirement be too onerous) if only the derivatives part of linked transactions is considered.

6.33 Some respondents argued that the level of any capital requirements in the OTC derivatives market should be consistent with the existing prudential or capital adequacy requirements imposed by the RBA.[526] The Advisory Committee notes, however, the current debate at the Basle/IOSCO level about whether the tests for determining levels of capital for banks are also appropriate for other financial institutions.[527] This would suggest that, in applying capital standards for non-exempt OTC market-makers, the ASC should consider, but not necessarily be bound to adopt, the capital requirements that apply to banks.

Prudential regulation: capital requirements

Recommendation 27. OTC market-makers (other than RBA-regulated entities and other exempt OTC market-makers) should be required to satisfy the ASC that they meet minimum capital standards applying to all their OTC derivatives trading activities.

The ASC should have the power to conduct surveillance to verify that these market-makers continue to meet minimum capital standards.

The ASC should have the power to suspend, or if necessary revoke, the licence of any of these market-makers if it considers that the licensee no longer meets minimum capital standards.

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required for ASX dealers to commence and remain in business be assessed according to the nature of the activities undertaken. This capital will vary depending upon whether the member is involved in any on-exchange margined derivatives transactions or, alternatively, any OTC derivatives transactions: at para 1.18. The ASX Document also proposes that the capital requirements for ASX dealers recognise the risk reduction benefits of hedging and portfolio diversification. Offsets between dealers' physical and derivative positions would also be permitted.

526 Westpac *OTC Submission*, AFMA *OTC Submission*.

527 The Report by the Technical Committee of IOSCO *The Implications for Securities Regulators of the Increased Use of Value At Risk Models by Securities Firms* (July 1995) stated that: "The Committee also recognises the growing importance of value at risk models in the securities industry and wishes to explore the possibility of considering the use of such models for the purposes of calculating Liquid Capital requirements. However, in light of ..... the much greater significance of market risk capital requirements for securities firms, the lack of data regarding the reliability of such models in practice, ... the Committee does not feel that it is appropriate at this stage for securities regulators to set a time scale for such a development" (at 15).

Chapter 7. Non-prudential regulation of derivatives market licensees

This Chapter deals with various proposed statutory or exchange-based obligations for holders of financial markets licences endorsed for on-exchange derivatives broking or advising or OTC derivatives broking, market-making or advising.

Client agreements

7.1 The purpose of client agreements is to set out the nature of the services to be provided by intermediaries and their legal relationship with their clients.

On-exchange

Brokers

7.2 Currently, on-exchange brokers and their clients must enter into broker-client agreements in a form stipulated by the Exchanges.[528] Copies of these agreements must be provided to the client.[529]

7.3 The Advisory Committee considers that financial exchanges should have the responsibility for devising client agreement forms and enforcing their use.

Advisers

7.4 Currently, there are no statutory obligations concerning the content of client agreements between on-exchange advisers and their clients. Also, the exchange rules have no application to those advisers who are not members of the exchange. The form of any client agreements between advisers and their wholesale clients could be left to private arrangements. However, retail clients should be protected through a statutory requirement for retail client agreement forms having minimum standard provisions. These provisions could be settled in consultation with industry bodies. The agreements should be entered into at the outset of the retail client-adviser relationship.

OTC

7.5 There are no prescribed client agreement forms in the Australian OTC derivatives market. This contrasts with some overseas approaches. For instance, the UK legislation requires that UK firms enter into signed agreements with their retail

528 For instance, SFE art 3.6(3)(k), First Schedule Part B, ASX rr 7.3.1.2, 7.3.1.5, 9.7.1, Appendices D2 (ordinary investors) and D3 (professional investors). Also, ASX r 10.4.2.7 provides that a clearing member in whose name a market contract is registered in a client account must have entered into a client agreement with the relevant client before the market contract is registered.

529 s 1210(b).

clients where the investment services involve contingent liability transactions. These agreements must cover the following core matters:

- a statement of the services to be provided
- the basis upon which the firm will charge for its services
- a statement of the customer's investment objectives (except in the case of execution-only services)
- any restrictions on investments or a statement that there are no such restrictions.[530]

7.6 In the case of brokers, these agreements must also include the following information where applicable:

- 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.[531]

7.7 The Advisory Committee considers that all OTC derivatives brokers, market-makers and advisers should be required to enter into client agreements with their retail clients at the outset of their legal relationship. These agreements should stipulate the nature and terms of the contractual relationship between them. Their form and content could be prescribed, following consultation between industry and the ASC.

7.8 The Advisory Committee does not consider that there should be mandatory client agreement forms for wholesale participants. These persons can negotiate their own arrangements with intermediaries.

Client agreements

Recommendation 28. There should be a statutory requirement for on-exchange advisers and OTC brokers, market-makers and advisers to enter into client agreements with their retail clients at the outset of their legal relationship. These forms should have minimum standard provisions, to be settled in consultation with industry bodies.

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530 UK Securities and Futures Authority Rules Table 5-23(4)(a).

531 UK Securities and Futures Authority Rules Table 5-23(4)(b).

Risk disclosure

Distinction between risk disclosure and "know your client" obligations

7.9 In this Report, the Advisory Committee deals separately with risk disclosure and "know your client" obligations. Risk disclosure focuses on the financial and other risks inherent in on-exchange and OTC derivatives trading. These risks apply equally to all participants. By contrast, the "know your client" obligation deals with the appropriateness of particular derivatives recommendations for individual participants, given their investment objectives, financial situation and particular needs.

Benefits of risk disclosure

7.10 On-exchange derivatives risk disclosure is a means for making market participants aware of both the nature and inherent risks of these markets and the risks involved in the types of products traded on them. For instance, some highly leveraged derivatives products may expose participants, for an extended period, to continuing financial obligations far in excess of the original outlay. Also, new exchange-traded derivatives products may generate novel financial risks which should be brought to the attention of market participants. These risks could be explained in risk disclosure statements.

7.11 OTC derivatives risk disclosure statements can explain the risks inherent in OTC market transactions and the legal relationships between counterparties to those transactions.

On-exchange

Current law

7.12 Currently, on-exchange brokers have statutory obligations to provide risk disclosure statements to their clients for all on-market futures transactions[532] (including futures options[533]) and share ratios.[534] In general, this obligation requires that they advise their clients of:

- the nature of these contracts
- the nature of the client's obligations

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532 s 1210. See also SFE By-law G.33 and Twenty Fourth Schedule. Additional risk disclosures apply for trading on NYMEX: SFE Fourth Schedule. SFE General By-law G.35 requires that risk disclosure documents be kept up to date.

533 Corporations Regulations From 804 provides for a ‘Risk Disclosure Statement’, which contains, *inter alia*, a specific warning on options:
'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.'
If any futures or options contracts are to be traded on foreign exchanges, another risk disclosure statement, ‘Foreign Futures and Foreign Options Risk Disclosure’, must be included. This statement highlights the general risks involved in trading on overseas exchanges for options and futures.

534 Corp Reg 1.2.10(1)(a) provides that s 1210 applies to share ratio contracts.

- the risks associated with this form of trading (by way of a prescribed form[535]), and
- the terms of the kinds of contract in which a broker deals on behalf of clients.

7.13 Risk disclosure obligations for warrants,[536] LEPOs and other Chapter 7 options, as well as share ratio contracts,[537] are imposed on dealers by exchange business rules. Comparable risk disclosure obligations apply on overseas exchanges that conduct markets in derivatives.[538]

Who should provide risk disclosures

7.14 The Advisory Committee notes that the current on-exchange risk disclosure obligations apply only to brokers, not advisers. It considers it important that eligible clients (see paras 7.15-7.17, below) receive risk disclosures when first consulting a derivatives intermediary. It may not be satisfactory to apply the obligation only to brokers, given that persons may first consult advisers and reach their trading decisions on the basis of that advice, prior to any dealing with brokers. Equally, it would not be appropriate that only advisers provide that information, as some clients may go directly to brokers. To ensure that all eligible clients receive these statements, the Advisory Committee considers that the obligation to provide them should apply to both brokers and advisers. This dual obligation would be less cumbersome than any rule that a broker or adviser is exempt from giving a risk disclosure statement if satisfied that the client has already received it from another source.

Who should receive risk disclosures

7.15 The Advisory Committee considers that all retail clients should receive risk disclosure statements.

7.16 It has also considered whether wholesale clients should receive these statements. The Committee notes that various sectors of the wholesale market, such as banks, superannuation funds and insurance companies, are already obliged to consider and

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535 Corp Regs Form 804 identifies these risks, which include that:
- the loss in futures trading can be substantial
- the client may sustain a total loss of the initial investment plus additional amounts which cannot be quantified at the time of entry into the contract
- under certain market conditions, it may not be possible to liquidate an open position.

536 ASX r 8.14.1. Appendix 6.17 requires brokers to provide professional and non-professional clients with an Explanatory Booklet explaining, inter alia, the risks of transacting in warrants. Recipient clients must also declare in the Client Agreement Form that they have received and read the Explanatory Booklet and must acknowledge the risks of trading warrants. The Offering Circular for warrants also requires disclosure of the risks, rights and obligations associated with warrants: ASX r 8.7.5.

537 ASX r 7.3.1.1(a), (b) (explanatory booklet and risk disclosure requirements). There is a specific disclosure obligation in relation to LEPOs: ASX r 7.3.1.7. Clearing members of the exchange must also give their clients updates of the explanatory booklets provided under these disclosure obligations: ASX rr 7.3.1.1(a), 7.3.3.1.

538 *CASAC Research Paper* at 72-75, 109-112, 127-132.

manage the risks involved in their derivatives transactions.[539] These obligations in effect require that they have a knowledge of the risks of derivatives trading. However, there are no similar specific requirements for other corporates or collective investment schemes.[540] Some managed funds and controllers of Australian corporates may be insufficiently aware of the potential hazards of using derivatives.[541]

7.17 The Advisory Committee considers that wholesale clients should not automatically lose the protection of risk disclosure. They should receive the generic and specific risk disclosure statements (see para 7.18, below) unless they have waived either right or both rights in writing. Corporate wholesale clients may do this only by resolution of their board of directors.

Types of risk disclosures

7.18 All retail clients and those wholesale clients who have not waived their rights (eligible wholesale clients) should receive two standardised forms of risk disclosure:

- *a generic risk disclosure statement*, describing the nature and inherent risks of on-exchange derivatives trading. Its contents could be prescribed by regulation[542]

- *specific risk disclosure statements*, describing the risks inherent in particular classes of exchange-traded derivatives. A financial exchange's business rules could prescribe the content of these disclosures for particular classes of derivatives (for instance, ASX-regulated warrants, share ratios).[543] There would need to be a legislative direction that advisers, as well as dealers, provide this information, given that advisers are not subject to exchange business rule requirements. Financial exchanges should be given legislative protection from any liability concerning the content of their mandatory disclosure statements.

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539 The Reserve Bank and the ISC impose and monitor these controls.

540 Corporate governance principles may oblige controllers of corporates and collective investment schemes to assess more closely the risks as well as the benefits of trading in derivatives.

541 See Parliamentary Joint Committee on Corporations and Securities, *Report on Derivatives* (November 1995) para 4.10: "Although some efforts are being made to educate users of derivatives, the Committee remains concerned that users of these products, including executives and directors of Australian companies, managed funds, trusts and individual investors, may not be sufficiently aware of the potential hazards of using derivatives".

542 See, for instance, Corp Regs Form 804. There are other forms of generic risk disclosure statements, for instance, the generic risk disclosure statement agreed to in July 1994 by the UK Securities and Futures Authority, the US Commodity Futures Trading Commission and the Central Bank of Ireland.

543 See, for instance, ASX r 8.14.1 (warrants). Corp Reg 1.2.10(1)(a) provides that s 1210 applies to share ratio contracts. This is supplemented by ASX rr 7.3.1.1(a), (b), 9.7.1, Appendix D1 which require dealers to provide clients with an explanatory booklet and a risk disclosure statement. The prescribed risk disclosure statement in ASX Appendix D1 contains sections dealing specifically with exchange-traded options, low exercise price options (LEPOs) and share ratio contracts. Clients must sign the risk disclosure statement. However, professional investors need not be given the explanatory booklet or the risk disclosure statement provided for in the ASX rules unless they specifically so request: r 7.3.1.3.

Procedures for giving risk disclosures

7.19 Advisers and brokers should give retail clients and eligible wholesale clients the generic risk disclosure statement at the outset of the professional relationship.[544] Advisers should give these clients specific risk disclosure statements at the time of first advising them about the relevant classes of on-exchange derivatives. Brokers should give these clients specific risk disclosure statements before first transacting for them in those classes of derivatives. Advisers and brokers need give generic and specific risk disclosure statements to their clients only once.

7.20 The legislation should require retail clients to provide written acknowledgement that they have received, read and understood the risk disclosure statements.[545] This would emphasise to retail clients their need to comprehend the risks of on-exchange derivatives trading. Advisers and brokers should have no further obligation to ensure that their retail clients have understood those risks. An adviser or broker should be prohibited from recommending or dealing in an on-exchange derivatives product for a new retail end-user without first receiving that written acknowledgment.

7.21 Eligible wholesale clients should not be required to provide the same written acknowledgement as retail clients. It should suffice that they have received the relevant risk disclosure.[546] They need not sign and return that disclosure.

Liability

7.22 Currently, a person who breaches the risk disclosure obligations in s 1210 is criminally liable. A criminal penalty provides a strong incentive for persons to comply fully with their risk disclosure obligations and should be preserved. In addition, advisers or brokers who fail to provide a risk disclosure statement, when required, should be civilly liable in damages to their clients for any loss that is attributable to that failure. However, to maintain the integrity of exchange clearing, no transaction should be void or voidable on that ground.[547]

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544 cf s 1210.

545 For instance, Form 804 (a generic risk disclosure statement) includes a requirement, not found in s 1210, that clients acknowledge that they have read and understood the risk disclosure statement. Also, ASX rr 7.3.1.1(b), (c), 7.3.1.7 and 9.7.1 require that a dealer not accept a person as a client to trade options (including LEPOs) and share ratio contracts unless the person has signed a risk disclosure declaration and entered into a client agreement. The agreement, to be signed by the client, contains a clause that the client has "read and understood the attached Risk Disclosure Statement" (Appendix D2, cl 3). SFE *Practice Note 10* is to the effect that risk disclosures should be signed by clients. In addition, the SFE client agreement form requires that the client acknowledge that trading in futures and options incurs the risk of loss as well as the prospect of profit: SFE First Schedule Part B cl 1.1(f).

546 BT *OTC Submission*. The ANZ *OTC Submission* pointed out that any obligation to obtain written acknowledgments of risk disclosures before dealing could create considerable practical difficulties in the wholesale market.

547 cf s 103(2). This approach was supported by Phillips Fox *OTC Submission*, Westpac *OTC Submission*, AFMA *OTC Submission* and IBSA *OTC Submission*.

OTC

Current law

7.23 There are no statutory risk disclosure obligations in the Australian OTC derivatives market. By contrast, the UK imposes risk disclosure obligations for off-exchange dealings with retail clients.[548] In practice, there are no risk disclosure obligations for the US OTC derivatives market.[549]

7.24 In some instances, a financial intermediary may be liable in tort (for instance, negligent misstatement) or under s 52 of the Trade Practices Act 1974 (Cth) (or its State equivalents) for misleading or deceptive conduct in misinforming clients (particularly non-expert clients) about the nature or extent of the risks involved in proposed derivatives transactions. Under certain circumstances, intermediaries may also have a common law duty to advise their clients of material changes involving a derivatives transaction, including changes to the value of OTC derivatives which may affect the clients' financial obligations.[550] Intermediaries are also subject to contract law principles (for instance, innocent, negligent and fraudulent misrepresentation).

7.25 However, these general laws may not create clear, consistent or comprehensive risk disclosure standards for this market.

Generic risk disclosure only

7.26 The Advisory Committee sees the purpose of any generic risk disclosure statement as informing recipients of the inherent nature and risks of OTC derivatives transactions, not protecting them against those risks.

7.27 The Advisory Committee accepts the view taken by many submissions that it would be impractical, and contrary to international practice, to prescribe any specific risk disclosure statements for particular classes of transactions in the OTC derivatives market (unlike the on-exchange market), given the often highly customised terms of

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548 *CASAC Research Paper* at 72-75.

549 *CASAC Research Paper* at 127 ff, particularly note 528, therein.

550 *Oabate Pty Ltd v Nichols Commodities Pty Ltd* (November 1983, Supreme Court of NSW). The nature and extent of this duty should be determined by the circumstances of each case. Relevant factors would include:

- the volatility of the market for the commodity in question
- the client's trading experience
- the availability of information concerning price movements to a client otherwise than through the broker
- the client's exposure to price movements
- any special instructions or practices, whether express or implied
- the availability of the client (M Hains, *Australian Corporation Law: Principles and Practice* (Butterworths) vol 3, para [8.1.0345]).

See also M Hains, "Duties and Obligations of a Futures Broker to his Client" (1987) 3 *Australian Bar Review* 122, E Kerr "Know Your Client: Counterparty Relationships", *Seminar on G-30 Recommendations One Year On*, 5 April 1995; G Hammond "Know Your contracts: Reflections on the collapse of Baring Brothers", *Seminar on G-30 Recommendations One Year On*, 5 April 1995.

particular transactions.[551] In practice, some market participants provide to their customers or counterparties their own risk disclosure statements explaining, for instance, the nature and risks of particular classes of OTC derivatives transactions and the legal relationship between the counterparties. Also, any person who provides personal advice about a particular OTC derivatives transaction should be obliged to disclose to the client (whether wholesale or retail) any specific material risks associated with that transaction.[552]

Who should provide and receive the generic disclosure

7.28 The Advisory Committee considers, for the same reasons as for on-exchange derivatives markets, that the generic risk disclosure statement should be given by OTC brokers and advisers to their retail clients at the outset of the professional relationship. Likewise, any OTC market-maker (including exempt OTC market-makers[553]) should provide that statement to a retail counterparty before first accepting that person as a counterparty. Each intermediary need give the risk disclosure statement only once to the retail end-user.[554]

7.29 The Advisory Committee has considered whether wholesale end-users should receive a generic risk disclosure statement from these intermediaries. It notes industry practice that wholesale participants receive industry-based generic risk disclosure statements unless they have waived that right.[555] The Advisory Committee considers that wholesale end-users should receive the generic risk disclosure statement unless they have waived this right. Corporate wholesale clients may do so only by resolution of their board of directors.

Acknowledgement of generic disclosure

7.30 Retail end-users should be required to provide written acknowledgment that they have received, read and understood that statement. This would emphasise to retail end-users the necessity for them to comprehend the risks of OTC derivatives transacting.[556] The terms of that acknowledgment should be set out in the prescribed

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551 See ANZ *OTC Submission*, ABA *OTC Submission*, Coopers & Lybrand *OTC Submission*, Treasury (formerly Attorney-General's Department) *OTC Submission*, Merrill Lynch *OTC Submission*, SFE *OTC Submission*.

552 Compare ASC Policy Statement 122.100.

553 Refer paras 5.68-5.69, supra.

554 The OTC DP proposed that risk disclosure statements be given annually. Various submissions, including ANZ *OTC Submission*, Coopers & Lybrand *OTC Submission*, Westpac *OTC Submission* and AFMA *OTC Submission*, opposed this requirement, arguing that it would impose considerable record-keeping and compliance costs disproportionate to any benefit to end-users. Corrs *OTC Submission*, Westpac *OTC Submission* and AFMA *OTC Submission* also pointed out that annual disclosure is not current practice in any existing market.

555 *AFMA Manual* Section 6 Chapter 4 para 3.1.

556 The ASC *OTC Submission* and the RBA *OTC Submission* supported a requirement that clients acknowledge that they have understood the risk disclosure. They argued that:

- it would emphasise to the client the need to understand such risks
- the requirement would be evidentially useful and protect the intermediary as well as the client

form (see para 7.33, below). OTC intermediaries should have no further obligation to ensure that their clients fully appreciate the risks of transacting in the OTC market.[557] This would overcome any doubts about whether any further obligation or liability rests on intermediaries.[558]

7.31 An intermediary should be prohibited from transacting with, or on behalf of, or recommending an OTC derivatives product to, a new retail end-user without first receiving that written acknowledgment.[559] However, there should be no mandatory delay (cooling off) period after receipt of the acknowledgment before trading can commence. A mandatory delay could disadvantage any retail end-users who need to enter the OTC derivatives market promptly. Also, it would create uncertainty as to the legal status of transactions entered into during any delay period.

7.32 Wholesale end-users who receive the generic risk disclosure should not be required to provide the same written acknowledgement as retail end-users. As with on-exchange transactions, it should suffice that they have received the generic risk disclosure statement.[560] They need not sign and return these statements.

Content of the generic disclosure

7.33 The content of any generic risk disclosure statement for OTC derivatives could be prescribed by regulation,[561] following consultation between industry and the ASC.[562] A standard form would ensure uniform disclosure and protect persons

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- the requirement would be consistent with the present requirement in relation to the risk of dealing in futures (see Corporations Regulations Form 804).

557 Merrill Lynch *OTC Submission*, Phillips Fox *OTC Submission*, RBA *OTC Submission*, Westpac *OTC Submission*, Treasury (formerly Attorney-General's Department) *OTC Submission*, AFMA *OTC Submission*, ASC *OTC Submission*, AARF *OTC Submission*, John O'Sullivan *OTC Submission* and SFE *OTC Submission* supported the proposal that the providers of risk disclosures should not be required to take reasonable steps to ensure that end-users understand those risks.

558 The ANZ *OTC Submission* and the ABA *OTC Submission* were concerned that a requirement of written acknowledgement might imply that intermediaries have some obligation to ensure that end-users do understand the risks of derivatives trading.

559 Phillips Fox *OTC Submission*, RBA *OTC Submission*, ASC *OTC Submission*, Treasury (formerly Attorney-General's Department) *OTC Submission*, IBSA *OTC Submission*, Merrill Lynch *OTC Submission* and AARF *OTC Submission* supported this approach. By contrast, Westpac *OTC Submission* and AFMA *OTC Submission* argued that this might delay the access of retail end-users to the derivatives market. The Advisory Committee notes that ASX r 7.3.1.1 requires that members ensure that clients sign the risk disclosure declaration provided for in the rules (ASX Rules Appendix D1) before entering into exchange transactions on their behalf.

560 BT *OTC Submission*. The ANZ *OTC Submission* pointed out that any obligation to obtain written acknowledgments of risk disclosures before dealing could create considerable practical difficulties in the wholesale market.

561 Compare the UK Investment Management Regulatory Organisation (IMRO) Derivatives Risk Warning Notice: IMRO Consultation Document 33 *Derivatives* (November 1996) at 32-38.

562 The *AFMA Manual* Section 6 Chapter 4 Attachment 1 sets out a voluntary code of risk disclosure for OTC market participants. The OTC DP proposed that the risk disclosure could be in any reasonable form. However, various submissions, for instance ANZ *OTC Submission* and Phillips Fox *OTC Submission*, were concerned that this proposal could create lack of certainty and the possibility of litigation. They favoured a standard risk disclosure statement, arrived at

providing the risk disclosure by avoiding any dispute about whether the disclosure was accurate and adequate.

7.34 A prescribed generic risk disclosure statement should explain the nature and inherent financial and legal risks of transacting in the OTC derivatives market.[563] It should also warn recipients that:

- all OTC transactions are principal-to-principal transactions. Parties are advised to assess the capacity of their counterparties to honour their contractual obligations. The OTC market may utilise clearing arrangements. These arrangements do not necessarily provide participants with the protections of exchange clearing

- transactions with market-makers are generally "arm's length" and do not usually put market-makers in any agency, fiduciary or advisory relationship with their counterparties, even where the market-maker has superior knowledge of the market generally or the particular OTC product.[564] Parties are advised to refer to the terms of any contract or agreement entered into between them and any other statements prepared by counterparties in determining their legal relationship. Parties might wish to receive independent legal advice before entering into these contracts. However, retail end-users who in fact receive personal derivatives recommendations have the protection of a "know your client" rule [as explained], regardless of any purported limitation in a particular contract, agreement or related statement

- there may be specific risks, which may not be apparent, associated with particular OTC derivatives transactions, given their often customised terms, or the identity of the counterparties [the ultra vires issue, as explained]. Persons are advised to seek independent professional advice on the appropriateness for them, and legal enforceability, of any contemplated OTC transaction

- the potential losses, as well as profits, from OTC derivatives transactions can be substantial. Also, a party may sustain a total loss which cannot be quantified at the time of entry into the transaction

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through industry participation. Westpac *OTC Submission* and AFMA *OTC Submission* also supported this industry participation.

563 See, for instance, *AFMA Manual* Section 6 Chapter 4, Attachment 1: Example Generic Risk Disclosure Statement. However, this may need to be revised if used for the purpose of a prescribed generic risk disclosure statement. For instance, the Advisory Committee recommends at para 7.58, post, that whether a person is providing personal advice should be determined by common law principles. It should not depend on whether there is a separate written advisory agreement (as contemplated by cl 5(ii) of the AFMA Statement).

564 This reflects the internationally adopted principle (reflected, for instance, in United States *Principles and Practices for Wholesale Financial Market Transactions* (August 1995)) that OTC transactions are generally arms-length.

- there may be no ability to liquidate or close out a particular OTC derivatives transaction, including under a stop-loss order, at all, or at or near its entry price, given the individualised nature of some OTC transactions, the possibly limited market in some types of transactions and the possible contractual restrictions on termination or transfer of a derivatives transaction

- market risk [as explained] is the responsibility of the party exposed to it. Subject to the terms of any agreement, neither a broker nor a counterparty is obliged to inform the client or the other party of any market price movements during the life of the transaction[565]

- there are no mandatory fidelity fund or indemnity insurance arrangements in the OTC market. OTC licensees are subject to minimum capital requirements. However, the amount of this capital requirement would not necessarily cover all or even a proportion of any monetary claim that might be made against them in certain circumstances

- transactions on electronic trading systems may be exposed to risks arising from the possible failure of computer hardware or software.

Liability

7.35 Liability for breach of the risk disclosure obligation should be similar to that proposed for on-exchange transactions.

Risk disclosure

Recommendation 29.

On-exchange risk disclosure

On-exchange brokers and advisers should give retail clients, and those wholesale clients who do not waive their right (eligible wholesale clients), generic risk disclosure statements at the outset of their professional relationship.

On-exchange brokers should give retail clients and eligible wholesale clients specific risk disclosure statements before first transacting for them in the relevant classes of derivatives.

On-exchange advisers should give retail clients and eligible wholesale clients specific risk disclosure statements at the time of first advising them about the relevant classes of derivatives.

565 The OTC DP raised the issue whether OTC brokers or market-makers should have any continuing or periodic mandatory reporting requirements to their clients or counterparties concerning the current market value, or level of exposure, of OTC derivatives contracts. Respondents to the OTC DP strongly opposed any such obligation, for instance, ABA *OTC Submission*, ANZ *OTC Submission*, Merrill Lynch *OTC Submission*, ISDA *OTC Submission*, AFMA *OTC Submission*, Westpac *OTC Submission*.

An on-exchange broker or adviser should be required to receive from a retail client written acknowledgement that the client has received, read and understood the risk disclosure statement before dealing in or recommending an on-exchange derivatives product for that client.

OTC risk disclosure

OTC brokers and advisers should give a generic risk disclosure statement to retail clients and eligible wholesale clients at the outset of the professional relationship. Likewise, OTC market-makers (including exempt OTC market-makers) should provide that generic risk disclosure statement to retail end-users and eligible wholesale end-users, before first accepting them as counterparties.

An OTC intermediary should be required to receive from a retail end-user written acknowledgement that the end-user has received, read and understood the generic risk disclosure statement. That acknowledgement must be received before first transacting with, or on behalf of, or recommending an OTC derivatives product to, that retail end-user.

Any person who provides personal advice about a particular OTC derivatives transaction should be obliged to disclose to the client (whether wholesale or retail) any specific material risks associated with that transaction.

Waiver

Corporate wholesale clients may waive their rights to receive all or any on-exchange or OTC risk disclosure statements only by resolution of their board of directors.

Liability

It should be an offence to fail to provide an on-exchange or OTC risk disclosure statement. Persons who fail to provide a mandatory risk disclosure statement should also be civilly liable in damages for any loss that is attributable to that failure. However, no transaction should be void or voidable due to failure to give risk disclosure.

General derivatives advice

7.36 The ASC has drawn a regulatory distinction between general advice and personal recommendations provided by securities advisers. General advice covers advice or reports provided to a person without any express or implied (direct or indirect) recommendation that any particular transaction is appropriate to the investment objectives, financial situation or particular needs of that person.[566] It may apply, for instance, to newsletters, circulars or advertisements.[567] The provision of general securities advice would not attract the "know your client" obligation of s 851,

566 ASC Policy Statement 122.9(e).
567 ASC Policy Statement 122.25.

which applies only to personal recommendations.[568] However, warnings are required when oral or written general securities advice is given.[569] These warnings should be to the effect that:

- the general advice has not taken into account the particular investment objectives, financial situation and needs of the recipient, and
- the recipient should assess that advice in that context.[570]

7.37 Also, the providers of general advice remain subject to common law disclosure and due care obligations, and possible licensee disciplinary action by the ASC in the event of default.[571]

7.38 The Advisory Committee considers that the same principles should apply to the giving of general advice concerning on-exchange or OTC derivatives. A person providing general derivatives advice should not be subject to a "know your client" obligation in relation to that advice.

General derivatives advice

Recommendation 30. A licensee providing general derivatives advice should warn recipients that:

- the general advice has not taken into account the particular investment objectives, financial situation and needs of the recipient, and
- the recipient should assess that advice in that context.

Personal derivatives recommendations

Current law

Corporations Law

7.39 Securities advisers (but generally not futures advisers[572]) are subject to a statutory "know your client" rule in giving personal recommendations to their clients concerning those on-exchange or OTC derivatives which currently are securities,

568 ASC Policy Statement 122.31. This is consistent with the Phillips Fox *OTC Submission* that widely circulated reports be excluded from the s 851 "know your client" rule.

569 ASC Policy Statement 121.72-84.

570 ASC Policy Statement 121.77.

571 ASC Policy Statement 122.38-39.

572 Limited suitability obligations apply to on-market futures dealers in opening or operating managed discretionary accounts on behalf of clients: SFE General By-law G.32(a)(iii). By contrast, the SFE client agreement form, which applies in all other circumstances, places the onus on the client to assess suitability by requiring "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" (First Schedule Part B cl 1.9).

including LEPOs, warrants, other share option contracts or share ratio contracts.[573] The adviser must have a reasonable basis for any personal recommendation made to the client. A personal recommendation covers any express or implied (direct or indirect) recommendation made by the adviser to the client that certain transactions are appropriate to that client, having regard to the client's investment objectives, financial situation and particular needs.[574] Some commentators refer to this requirement as a suitability rule.

7.40 A "know your client" rule does not require the adviser to provide a personal recommendation in any particular case or, in so doing, to provide best advice.[575] Rather, according to the ASC, it imposes a positive requirement on advisers who make personal recommendations to:

- have regard to the information they have about their clients' investment objectives, financial situation and particular needs. To this end, advisers should either have adequate information about these matters or make reasonable inquiries from clients to obtain that information[576]
- conduct reasonable investigation and product research about the transactions recommended, and
- prepare their recommendations in light of these considerations.[577]

7.41 These requirements may be modified for execution-related telephone advice, other than for new clients.[578] Advisers making personal recommendations must also warn clients who decline to provide full relevant information[579] and tell their clients about any significant risks associated with the transaction.[580]

7.42 The "know your client" rule does not impose a specific obligation on an adviser to keep relevant records. However, the ASC has interpreted the rule as, in effect, requiring advisers to keep records of their clients' profiles and their product research.[581]

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573 s 851. The defences are set out in s 852. See also ASX r 7.3.1A. For share ratios, see Corp Reg 1.2.03 and ASX r 9.7.2. For warrants, see ASX r 8.14.2.

574 Compare ASC Policy Statement 122.9(l) definition of "personal securities recommendation".

575 ASC Policy Statement 122.98. This is also reflected in the available defences: ASC Policy Statement 122.117-118.

576 The ASX business rules impose a requirement on brokers, before accepting an order to enter into an exchange transaction for a person for the first time, to "make reasonable enquiries to learn the investment objectives, financial situation and particular needs of that person and retain the information obtained from these enquiries in a form readily available for inspection by the Exchange": r 7.3.1.1(e). Exchange members do not have to comply with this requirement for professional investors unless those investors make a specific request: r 7.3.1.3.

577 Policy Statement 122.99-116.

578 Policy Statement 122.140, 143. See also ASX Business Rule Guidance Note 7/96 "Execution Related Telephone Advice" (30 September 1996).

579 Policy Statement 121 Part V, Policy Statement 122.106-107, 143. An adviser should record whether or not a warning has been given that the adviser did not have sufficient information about the client to make a recommendation or give appropriate advice: ASX Business Rule Guidance Note 7/96 "Execution Related Telephone Advice" (30 September 1996) at 4.

580 ASC Policy Statement 122.100.

581 ASC Policy Statement 122.126-130, 146.

7.43 Advisers and clients cannot limit or exclude the "know your client" obligation.[582] Advisers are subject to civil, but not criminal, liability for breach of this rule, and may also have their licences suspended or revoked.[583]

7.44 The "know your client" rule currently applies for the benefit of wholesale and retail clients. However, the ASC questions whether, in principle, it should cover wholesale clients.[584] The Commission considers that these clients should have the necessary levels of resources, expertise and experience to choose and monitor the quality of advisory services. Also, wholesale clients may have different and more complex advisory service needs than retail clients. The terms of advisory contracts and arrangements between wholesale clients and their advisers are better left to individual negotiation rather than prescription in the Corporations Law.[585] Given this, the ASC will focus its surveillance activity on persons providing advisory services to retail clients.[586]

Other law

7.45 Securities or futures advisers who provide personal advice to their clients may be liable, for instance:

- in tort or under s 52 of the Trade Practices Act 1974 (Cth) (or its State equivalents) for deceit, misstatement or misleading or deceptive conduct,[587] or
- in contract for innocent, negligent and fraudulent misrepresentation.[588]

7.46 Any advice provided by an adviser must be given honestly and with appropriate skills and ability.[589]

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582 ASC Policy Statement 122.119.

583 ASC Policy Statement 122.41-42.

584 ASC Policy Statement 122.154.

585 ASC Policy Statement 122.147-148.

586 ASC Policy Statement 122.155.

587 See E Kerr, "Know Your Client: Counterparty Relationships", *Seminar on G-30 Recommendations One Year On*, 5 April 1995; G Hammond, "Know Your Contracts: Reflections on the collapse of Baring Brothers", *Seminar on G-30 Recommendations One Year On*, 5 April 1995. In some instances, silence or half-truths may be misleading or deceptive. In *Demagogue Pty Ltd v Ramensky* (1992) 110 ALR 608 at 609-10, the Full Federal Court noted, in relation to s 52 of the Trade Practices Act, that "the primary question was whether there had been conduct that was misleading or deceptive or likely to mislead or deceive. In this case, as in every case in which s 52 is relied upon, this was a question of fact that could only be determined ... having regard to all the relevant circumstances. Silence is to be assessed as a circumstance like any other. To say this is certainly not to impose any general duty of disclosure; the question is simply whether, having regard to all the relevant circumstances, there has been conduct that is misleading or deceptive or that is likely to mislead or deceive. To speak of ‘mere silence’ or of a duty of disclosure can divert attention from that primary question. Although ‘mere silence’ is a convenient way of describing some fact situations, there is in truth no such thing as ‘mere silence’ because the significance of silence always falls to be considered in the context in which it occurs. That context may or may not include facts giving rise to a reasonable expectation, in the circumstances of the case, that if particular matters exist they will be disclosed."

588 See further *CASAC Research Paper* at 48-49.

7.47 These remedies are not comprehensive as:

- neither the common law nor the Trade Practices Act s 52 imposes any specific obligation to make reasonable inquiries of clients or conduct product research
- it is possible to contract out of some common law rights[590]
- the ASC lacks a direct role in enforcing common law rights.[591]

Arguments for and against an on-exchange and OTC "know your client" rule

7.48 The Advisory Committee is aware of the continuing international debate on applying "know your client" obligations to derivatives intermediaries.[592] This is reflected in the competing arguments, referred to in submissions, about whether advisers should be under any "know your client" obligation concerning their on-exchange or OTC derivatives recommendations, as set out below.

- A "know your client" obligation has not previously been applied to exchange-based futures trading in Australia, except for managed discretionary accounts (where the dealer can make and execute trading decisions for the client).[593] This obligation is appropriate for securities transactions, but cannot be applied to derivatives transactions, given the different nature and risk implications of securities and derivatives.[594] There are no identified instances where derivatives participants have suffered through the lack of a general "know your client" requirement. A contrary view is that Australian law already has this requirement for some

589 *Option Investments (Aust) Pty Ltd v Martin* [1981] VR 138 at 142.

590 However, SFE art 3.6(3)(k) prohibits member brokers from including in their client agreements any terms whose effect or purported effect would be to exclude or limit the member's liability for negligence, fraud or dishonesty.

591 The power of a regulator to intervene must be based on statute. For instance, s 851(3) provides that a breach of s 851 constitutes a contravention, though not amounting to a criminal offence. The ASC may exercise its investigative and other information-gathering powers in regard to any contravention of the Corporations Law: ASC Law s 13(1). These powers are not exercisable where common law rights only are involved.
The ASC Law s 50 permits the ASC to commence civil proceedings in the names of individuals as a result of an investigation. This power is predicated on the ASC exercising its investigative powers.

592 The European Council Directive of 10 May 1993 requires that an investment firm must "seek from its clients information regarding their financial situations, investment experience and objectives as regards the services requested" (article 11). These requirements are found in the UK legislation: *CASAC Research Paper* at 79-81, cf Canada at 113-115. US "know your client" rules are not directed at the OTC market: id at 133-134.

593 SFE By-law G.32(a)(iii) requires that "a Member shall not open or operate a Managed Discretionary Account on behalf of a potential or existing client 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".

594 These arguments are summarised in P Hanrahan, "The Proposed Suitability Requirement for On-exchange Derivatives Markets: A Critical Analysis" *Journal of Banking and Finance Law and Practice* vol 8, March 1997 5 at 18-20.

derivatives (LEPOs, warrants, other share option contracts and share ratio contracts) as do some major overseas jurisdictions.[595]

- Risk disclosure statements should put clients on notice of their need to assess whether particular derivatives transactions are appropriate for them.[596] However, retail clients may lack this capacity, particularly with complex products. Risk disclosure alone may not suffice to enable retail end-users to determine whether particular derivatives transactions are appropriate for them.[597]

- A "know your client" obligation on advisers may reduce the incentive for clients to determine for themselves whether particular derivatives transactions are suitable for them, or to exercise prudence in their trading decisions. Clients could interpret a "know your client" obligation on advisers as either a guarantee of successful derivatives trading or the transfer to advisers of all or part of the risk of loss in that trading (the "moral hazard" problem). However, a "know your client" rule does not provide any guarantee against loss. It does not require that the adviser provide "best advice".[598] It applies only where an adviser "does not have a reasonable basis for making the recommendation".[599]

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595 For instance, the UK legislation imposes "know your client" obligations for, in effect, retail clients. Principle 4 of the UK Securities and Investments Board Statement of Principles states that "a firm should seek from customers it advises or from 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." UK Securities and Futures Authority r 5-31 requires that recommendations given to retail clients must be suitable having regard to facts disclosed by that client and any other relevant facts about the client of which the firm is, or reasonably should be, aware. Under UK Investment Management Regulatory Organisation (IMRO) r 3.1(1), a Firm has an overriding duty to ensure that any investment which it recommends, or any transaction which it effects or arranges in the exercise of discretion, is suitable for the customer concerned. There are comparable Canadian "know your client" obligations: *CASAC Research Paper* at 113-115. The United States "know your client" rules, imposed by the exchanges, are confined to options: id at 133-134. There is continuing debate in the US on whether a statutory "know your client" rule should be enacted. For instance, a joint statement by the US Securities and Exchange Commission, the US Commodity Futures Trading Commission and the UK Securities and Investments Board, *OTC Derivatives Oversight* (March 1994) Section V proposed a suitability requirement for retail clients in OTC derivatives transactions.

596 For instance, Form 804 (the risk disclosure statement provided to clients) states that "the risk of loss in trading in futures contracts can be substantial. You [the client] should therefore carefully consider whether that kind of trading is appropriate for you in the light of your financial circumstances."

597 The *ASX Submission to the Federal Attorney-General on Share Ratios* (August 1994) supported applying the "know your client" rules to share ratio contracts. The submission argued that "in the interests of investor protection, it would not be enough for the statute to oblige the adviser to supply the client with a risk disclosure statement and then leave the client unassisted" (para 13.7).

598 ASC Policy Statement 122.98.

599 s 851(1)(b). The Advisory Committee considers that s 851 does not provide any such guarantee. It is inherent in the nature of derivatives products that participants may suffer losses. Retail participants will be informed of this through risk disclosure.

- Clearing house margining requirements may offset the lack of a general "know your client" rule by alerting clients to the continuing costs of their on-exchange derivatives trading and the possible need to reduce or extinguish their exposures through close-out of their open positions.[600] A contrary view is that a "know your client" rule may reduce the likelihood of clients entering into inappropriate derivatives transactions in the first place. At best, margin requirements can prompt clients to thereafter limit their on-exchange losses.

- A "know your client" obligation may be unnecessary in the OTC market, where participants themselves usually assess their counterparties. However, this assessment may only deal with the threshold decision whether, for instance, to accept a new client as a counterparty, and may focus only on whether that person's credit profile is satisfactory. This assessment does not necessarily deal with whether the transaction is appropriate for the counterparty, given that person's investment objectives, financial situation and particular needs.[601]

- A "know your client" rule may create barriers to entry. Potential liability for breach of any such rule may discourage advisers from making personal recommendations to those clients who have the protection of this rule.

7.49 An alternative approach is to encourage voluntary "know your client" standards and codes of conduct to supplement common law rights. Some submissions preferred this approach.[602] However, the Advisory Committee queries whether the derivatives industry is likely to develop guidelines that impose, rather than seek to exclude, these obligations, given overseas trends. For instance, the International Securities Dealers'

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600 M Starr, Policy Director, Government and Legislative Affairs, SFE, in his Paper *Introduction to Derivatives* (NSW Young Lawyers Accounting and Derivatives Seminar 30 May 1996) said: "The absence of a suitability rule for futures trading is offset by the rigorous daily margining routine designed to detect those customers who may be financially unable to survive extensive volatility in the underlying share, or extended depreciation (appreciation) in the value of the share ... [This is] more rigorous, appropriate and relevant for futures trading as compared to the subjective know your client test". The BT *On-exchange Submission* endorses Malcolm Starr's argument that the existing margining system is an effective deterrent for inappropriate clients.

601 For instance, the United States Office of the Comptroller of the Currency (which regulates US national banks) has concluded that a bank entering into derivatives transactions should assess the "appropriateness" of a transaction for a counterparty in order to protect itself from credit and legal risk. This obligation is substantially different from a "know your client" obligation which would be imposed for the protection of the counterparty.

602 ABA *OTC Submission*. ISDA *OTC Submission* cited the United States *Principles and Practices for Wholesale Financial Market Transactions* (August 1995), which sets out the correct relationship between participants: each participant must be responsible for its own decision to enter into transactions, and may not rely on its counterparties for recommendations or investment advice, unless there is a written agreement to the contrary. Merrill Lynch *OTC Submission* said that an intermediary should clarify the "arm's length" nature of the relationship if the intermediary becomes aware that its counterparty believes incorrectly that the intermediary has assumed advisory or similar responsibilities. AFMA *OTC Submission* made the same point. The Securities Industry Association *OTC Submission* also pointed out, referring to the DPG's "Principles & Practices" Framework dealing with "Counterparty Relationships", that financial markets, particularly those involving sophisticated participants, are moving away from imposing "suitability" obligations on intermediaries.

Association voluntary code of conduct for wholesale OTC markets provides that, in general, participants will be treated as not having relied upon each other for recommendations or advice.[603] A similar approach of discouraging any attempt to introduce a "know your client" standard was taken by the US Derivatives Policy Group.[604]

Applying a "know your client" rule to on-exchange and OTC derivatives advice

Wholesale clients

7.50 Taking these arguments into account, the Advisory Committee considers that a "know your client" rule applying to personal recommendations by derivatives advisers should only be introduced if there is a compelling consumer protection justification. This does not apply to wholesale end-users.

7.51 Most submissions[605] opposed a "know your client" rule for wholesale clients. They argued that these participants can, or reasonably should be able to, protect their own interests by implementing procedures to understand and manage the risks involved in derivatives transactions.[606] They should be sufficiently knowledgeable to make their own judgments on the merits of derivatives transactions, or obtain independent professional assistance.[607] Furthermore, they may be better placed than retail participants to negotiate the standard of professional advice and any remedies for default. Also, a "know your client" rule would place the Australian wholesale derivatives market at a competitive disadvantage.[608]

7.52 The Advisory Committee agrees. However, wholesale (as well as retail) end-users who obtain advice should have a protection based on s 995 (which provides a civil remedy for misleading or deceptive conduct in relation to securities) against the adviser. This should be in addition to existing common law remedies.

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603 Draft United States *Principles and Practices for Wholesale Financial Market Transactions* (March 1995). See summary in N Jacklin, "Sales practices in OTC derivatives transactions", *Butterworths Journal of International Banking and Financial Law* vol 10 No 4 April 1995 at 181, *Derivatives Week* 10 July 1995: "The nub of the paper is to make clear that in the marketing and sales of all over-the-counter derivative products the firms are not acting as financial advisors to the companies buying the products. As such, the firms are not making assessments on the appropriateness of clients' objectives in using the specific OTC products being marketed".

604 See US Derivatives Policy Group *Framework for Voluntary Oversight* (March 1995) at 37 ff (Counterparty Relationships).

605 AFMA *OTC Submission*, IBSA *OTC Submission*, ISDA *OTC Submission*, Merrill Lynch *OTC Submission*, Securities Industry Association *OTC Submission*, Phillips Fox *OTC Submission*, John O'Sullivan *OTC Submission*, SFE *OTC Submission*, ABA *OTC Submission*.

606 The *Futures Industry Association Financial Integrity Recommendations* (June 1995) Recommendations 56 and 57 state that the board of directors or senior management of a sophisticated end-user should understand its proposed derivatives trading activities and establish general risk management guidelines and procedures for these activities.

607 cf *AFMA Manual* Section 6 Chapter 4, paras 4, 5.

608 For instance, the Bank of England has decided that it would not be appropriate to extend to corporate end-users the concept of suitability that applies to retail end-users: *Butterworths Journal of International Banking and Financial Law* October 1996 at 425.

Retail clients

7.53 In contrast to wholesale clients, the Advisory Committee considers that retail clients should have the protection of a statutory "know your client" rule where derivatives advisers provide personal recommendations concerning on-exchange or OTC derivatives transactions. Retail participants could reasonably be expected to rely on this advice when deciding to transact in derivatives.[609] They may also lack the knowledge and bargaining power to negotiate the standards to apply to advice given. Various respondents supported this approach.[610]

7.54 The content of a "know your client" rule for retail clients should be the same as that for the giving of securities advice, as applied by the ASC.[611]

7.55 The reasons for introducing this obligation for the benefit of retail but not wholesale clients, as summarised by one respondent,[612] include:

- *the rationale of regulation is different.* "Consumer protection" is irrelevant for wholesale markets, in which the main purpose of regulation is to protect the market from failure. By contrast, in the retail markets, systemic protection and consumer protection are equally important
- *access to remedies.* "Consumer protection" regulation is primarily designed to tilt an uneven playing field in favour of a disadvantaged party. In a wholesale market the playing field is already even. Wholesale participants can easily use contractual remedies, TPA s 52 and remedies for negligence and breach of fiduciary duty
- *best use of regulatory resources.* Limited ASC regulatory resources should be used for retail end-users
- *international competition.* The wholesale market, which is essentially international, must not be hindered by regulations not found outside Australia, unless completely necessary.

7.56 The "know your client" obligation should only apply to on-exchange or OTC advisers giving personal derivatives recommendations. One respondent pointed out that a "know your client" rule, which requires the intermediary to make reasonable enquiries about the client's financial situation, needs and investment objectives, may be apt for financial advisers, but would be impossible to apply, for instance, to brokers who merely execute transactions.[613] The Advisory Committee agrees. Its proposed "know your client" rule would not apply to broker-client relationships.[614] Likewise,

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609 cf ASC Policy Statement 116.7.

610 For instance, IBSA *OTC Submission*, Merrill Lynch *OTC Submission*, Phillips Fox *OTC Submission*, Treasury (formerly Attorney-General's Department) *OTC Submission*, ASCT *OTC Submission*, ASC *OTC Submission*.

611 Policy Statement 122.99-116.

612 John O'Sullivan *OTC Submission*.

613 ABA *OTC Submission*.

614 One view put forward by critics of the "know your client" rule is that it could conflict with the principal-agent relationship between clients and brokers and lead to costly delays in the execution of transactions. It might also impose a duty on the broker to refuse to accept certain client orders. These views are summarised in P Hanrahan, "The Proposed Suitability

any assessment of a retail end-user by a potential counterparty who is not that end-user's adviser, would not, of itself, constitute the giving of a personal recommendation. This would not attract any "know your client" obligation.

7.57 The Advisory Committee notes that various contract agreements and related statements currently used in the OTC derivatives industry contain a form of reverse suitability[615] or provide that advice has not been given except where, for instance, the parties are subject to a separate written advisory agreement. However, the Advisory Committee considers that persons who in fact provide advice to retail end-users should be subject to the "know your client" requirements, regardless of the terms of any particular agreement or related statement. The generic risk disclosure statement will advise retail end-users of their "know your client" protections.

7.58 The test of what constitutes giving advice, as contrasted with simply providing information, should be left to common law principles.[616]

7.59 The Advisory Committee recognises the need to tailor any "know your client" rule to the nature and risk characteristics of derivatives transactions. These transactions are often designed to accommodate a specific financial or business need, and may involve a considerably greater financial risk than securities or other financial market transactions. Hence, any requirement that an adviser fully "know the client" before making a personal recommendation could require the adviser to obtain detailed information about a retail client's financial and commercial position, and their appreciation, and willingness to take the risks, of derivatives transactions. In some cases, a retail end-user may be unwilling to provide full disclosure. Also, persons who only manage part of a client's portfolio may not have all the information required to make a full assessment of their client.[617]

7.60 To overcome these problems, an adviser should not be obliged to obtain, or the retail client to provide, full personal information. Advisers should make any personal recommendations on the basis of information their retail clients provide to them in response to their reasonable inquiries and any other information known to them.[618] This would overcome the possible objection that a "know your client" rule could interfere with a client's privacy.[619] However, an adviser should be required to provide appropriate warnings to retail clients who decline to provide relevant information.[620]

Requirement for On-exchange Derivatives Markets: A Critical Analysis" *Journal of Banking and Finance Law and Practice* vol 8, March 1997 5 at 19. These concerns are inapplicable to a "know your client" rule that is confined to advisers and only in their giving personal recommendations to their clients.

615 For instance, some agreements or statements seek to impose on the client the responsibility for determining whether derivatives trading is appropriate for them in light of their experience, objectives, financial resources, overall financial sophistication and other relevant circumstances.

616 See *Bankers Trust v Dharmala* (1995) 4 BLR 381.

617 AIMA *OTC Submission*, ISDA *OTC Submission*.

618 cf ASC Policy Statement 122.101.

619 This concern was raised in the *SFE Submission on the First Exposure Draft of the Futures Industry Bill 1985* para 6.2. See also P Hanrahan, "The Proposed Suitability Requirement for On-exchange Derivatives Markets: A Critical Analysis" *Journal of Banking and Finance Law and Practice* vol 8, March 1997 5 at 18.

620 cf ASC Policy Statement 121 Part V; ASC Policy Statement 122.106-107, 143.

7.61 The Advisory Committee recognises that a "know your client" obligation may discourage some advisers from providing personal recommendations to their retail clients. One policy option would be to permit a retail client to opt out of the "know your client" protection. However, the Committee does not support this option. If adopted, it may result in many derivatives advisers requiring retail persons to sign an opt-out clause as a condition of being accepted as a client.

Consequences of breach

7.62 To maintain the integrity of any clearing house, and protect counterparties in OTC transactions, on-exchange or OTC derivatives transaction should not be void or voidable as a result of any breach of the "know your client" rule.[621]

7.63 Instead, remedies for breach of the "know your client" rule should be the same as for the securities provisions. Similar defences should apply.[622] However, to avoid duplicate statutory remedies, a statutory "know your client" rule should exclude any remedies under the Trade Practices Act. Also, failure by a derivatives adviser to meet the "know your client" standard could be relevant in considering the continued fitness of the adviser to be licensed.[623]

Personal derivatives recommendations

Recommendation 31. On-exchange and OTC derivatives advisers who make personal derivatives recommendations to retail clients should be required, regardless of any purported limitation in a particular agreement or other related statement, to:

- have regard to the information advisers have about their clients' investment objectives, financial situation and particular needs
- make reasonable inquiries from clients where that information is not adequate
- conduct reasonable investigation and product research about the securities recommended, and
- prepare their recommendations in light of these considerations.

Advisers should be required to provide appropriate warnings to retail clients who decline to provide relevant information.

Advisers who breach the "know your client" requirement should be liable to their retail clients civilly in damages for any loss that is attributable to that breach. However, no transaction should be void or voidable due to a breach.

There should be a prohibition on misleading or deceptive conduct in relation to the giving of any derivatives advice.

621 cf s 103(2).

622 cf s 852, ASC Policy Statement 122.41-42. This civil remedy was supported by Phillips Fox *OTC Submission*, ABA *OTC Submission*, John O'Sullivan *OTC Submission*.

623 John O'Sullivan *OTC Submission*.

Conflict of interest

7.64 In all financial markets, it is essential to have rules to ensure that the interests of intermediaries do not conflict with their duties to their clients. These rules need to deal with intermediaries acting as counterparties to their clients and advisers receiving benefits as a result of their recommendations. However, the nature of these rules can vary depending on the type of market involved.

Acting as counterparty to client

On-exchange

7.65 Currently, on-exchange futures brokers may only take the other side of a client's transaction with the client's consent.[624] Also, there is a prohibition on securities brokers dealing on their own account with their clients, without first informing those clients that they are so acting.[625] In addition, the exchange business rules require that clients be informed that the broker may act as a counterparty in on-exchange transactions.[626]

7.66 The Advisory Committee considers that on-exchange derivatives brokers should not be permitted to enter into on-exchange derivatives transactions with their clients without first obtaining their consent.

OTC

7.67 By definition, the function of OTC broking does not involve the broker acting as a counterparty to the client. Therefore, no conflict of interest issue arises.

7.68 It is normal practice for OTC market-makers to act as counterparties.[627] For this reason, many submissions opposed any statutory requirement that market-makers obtain the consent of their counterparties before entering into OTC transactions with

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624 s 1208(3). This provision also permits futures brokers to take the other side of their clients' transactions where they are to be taken to be dealing on their own account. However, the meaning of this is obscure.

625 s 843. However, the effect of Corp Regs 1.2.06(a) and 1.2.10(1)(a) is that s 1208(3), rather than s 843, applies to share ratio contracts.

626 For instance, ASX Appendices D2 cl 8 (ordinary investors) and D3 cl 6 (professional investors). SFE General By-Laws G.32(g) and G.41(b) require a member who operates a managed discretionary account on behalf of a client to report to the client any transactions effected in relation to the account where the member on its own account takes the opposite position to that client. The SFE client agreement form requires clients to acknowledge the right of a member to act as a counterparty in their transactions: First Schedule Part B cl 1.2(b), also Part BB cl 3(b).

627 "While dealers in the early [OTC] derivatives markets simply acted as brokers by finding counterparties with off-setting requirements, they subsequently began to act as counterparties themselves by actively taking positions which would then be hedged by either entering into matching transactions or warehousing a position until a suitable opposing contract could be found with the [on-exchange] futures market being used to hedge unwarranted risks." January 1996 *Journal of Business Law* at 69.

them.[628] The Advisory Committee agrees. It supports industry-based conventions to avoid conflicts of interest.[629]

Acting as counterparty to client

Recommendation 32. On-exchange derivatives brokers should not be permitted to enter into on-exchange derivatives transactions with their clients without first obtaining the consent of those clients.

Benefits disclosure

Current law

7.69 Securities advisers, though not futures advisers, must disclose to clients particulars of any material benefits, advantages or other interests which may affect their personal recommendations.[630] This obligation potentially applies to a wide range of interests.[631] The disclosure must be in a manner which is clear and easily understood by the client.[632] The method, and frequency, of benefits disclosure might differ depending, for instance, on whether the personal recommendation was oral or written and whether it involved execution-related telephone advice.[633] Also, where clients are referred to an adviser by a referring party, the adviser must disclose details of any fees, commissions or other benefits payable to the referring party by virtue of that reference.[634]

7.70 There is no statutory requirement that records of these disclosures be kept. Nevertheless, the ASC considers that record-keeping is highly desirable to protect all

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628 For instance, Phillips Fox *OTC Submission*, ISDA *OTC Submission*, John O'Sullivan *OTC Submission*, SFE *OTC Submission*.

629 *AFMA Manual* Section 3, CC 310 states: "Members should ensure that formal procedures exist to identify and mitigate potential conflict of interest situations that may occur at an organisational level or at an individual level. Individuals must ensure that their personal business, investment and other activities (including those of family members and other close associates) do not place them in a position where their own interests may influence judgments or actions they take on their employer's or client's behalf. Where such conflicts of interest occur, the individuals should declare them promptly to senior management and withdraw from any transactions which give rise to the conflict. In all cases, management guidelines must be followed."

630 s 849. See also ASX Business Rule Guidance Note 8/96 "Disclosure of Interests and Securities Recommendations" (30 September 1996).

631 ASC Policy Statement 122.45 ff refers to a range of possible disclosable benefits, including trailing commissions, soft dollar arrangements and cumulative rewards. Fees received from the client are excluded: ASC Policy Statement 122.72 ff.

632 ASC Policy Statement 122.78-79.

633 ASC Policy Statement 122.80-89, 138. ASX Business Rule Guidance Note 8/96 "Disclosure of Interests and Securities Recommendations" (30 September 1996) states (at 4) that: "When recommendations are made orally, the disclosure should be made orally in as simple terms as possible. Where recommendations are made in writing, the disclosure should also be made in writing in language which is easy to understand."

634 ASC Policy Statement 120.30. The ASC imposes this obligation as a condition of an adviser's licence.

parties, ensure the proper handling of clients' complaints, and assist in surveillance and enforcement of the benefits disclosure requirements.[635]

7.71 Benefits disclosure may assist clients to assess any recommendation more critically and reduce the opportunity for advisers to act through self-interest.[636] There are criminal and civil consequences for breach.[637] Also, the ASC may take disciplinary action against defaulters.[638]

7.72 These statutory disclosure obligations apply whether the client is a wholesale or retail market participant. However, the ASC does not consider that, in principle, these obligations should apply to wholesale clients.[639] The Commission will focus its surveillance activity on benefits disclosure to retail clients.[640]

On-exchange and OTC

7.73 The Advisory Committee considers that comparable benefits disclosure requirements should apply to advisers who provide personal recommendations for either on-exchange or OTC derivatives transactions. Submissions generally supported this disclosure requirement.[641] The Committee also agrees with submissions that this obligation should be confined to advisers dealing with retail end-users.[642] The Financial System Inquiry also recommended that there be appropriate disclosure of remuneration or commissions paid to advisers concerning retail financial products.[643]

7.74 The Advisory Committee recognises that, as with securities benefits disclosure, it is not always easy to decide when a benefit, advantage or interest is a disclosable interest.[644] This may be essentially a question of fact which the adviser may be best placed to determine.[645] However, it would be appropriate to specifically exclude from this disclosure requirement any actual or anticipated transaction profit to an OTC adviser who is also the intended counterparty to that recommended OTC derivatives transaction. It is reasonable to assume that this person has a pecuniary interest in the transaction and may profit from it. The price offered by this person (and hence the profit element implicit in the contract terms) could be ascertained by comparison with the terms provided by other market-makers for a similar derivatives contract. Also, it

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635 ASC Policy Statement 122.120-125, 144-145.

636 ASC Policy Statement 122.44. However, the disclosure does not reduce the obligation of the adviser to act in the best interests of the client: ASX Business Rule Guidance Note 8/96 "Disclosure of Interests and Securities Recommendations" (30 September 1996) at 1.

637 ASC Policy Statement 122.40-41. The defences in ss 850(1) and (2) and 852(3) are discussed in ASC Policy Statement 122.90-96.

638 ASC Policy Statement 122.42.

639 ASC Policy Statement 122.154.

640 ASC Policy Statement 122.155.

641 Phillips Fox *OTC Submission*, AFMA *OTC Submission*, Westpac *OTC Submission*, ABA *OTC Submission*.

642 For instance, BT *OTC Submission*, ANZ *OTC Submission*.

643 *Financial System Inquiry Final Report* Recommendations 8 and 15.

644 The Phillips Fox *OTC Submission* pointed to the difficulty of assessing whether some financial benefits might be sufficiently material to affect an adviser's recommendation.

645 The ASC takes this view in Policy Statement 122.50.

may be impossible to determine the level of any profit from a transaction until it is completed, possibly months or years after entry into the transaction.[646]

7.75 The Advisory Committee notes the UK requirement that the amount of fees and benefits must not be unreasonable in the circumstances. The Committee does not favour any comparable statutory controls in Australia on the level of fees charged, or other benefits received, for on-exchange or OTC transactions. Respondents agreed.[647] This should be left to competitive market forces. Also, the benefits disclosure requirements proposed by the Advisory Committee should alert clients to hidden or excessive fees or benefits.

Benefits disclosure

Recommendation 33. On-exchange and OTC derivatives advisers should be required to disclose to their retail clients particulars of any material benefits, advantages or other interests which may affect their personal derivatives recommendations. There should be a specific exemption for any actual or anticipated transaction profit from a recommended OTC derivatives transaction where an OTC adviser is also the intended counterparty to that transaction.

Contract notes

7.76 The purpose of contract notes is to inform clients of the terms of the on-exchange or OTC derivatives contracts into which they have entered. Contract notes provide an immediate record of all the key terms of these transactions. Without them, it may be difficult for parties to enforce their contractual rights or resolve disputes about their obligations.

On-exchange

7.77 Currently, futures brokers and securities dealers must provide contract notes to their clients, with limited exceptions.[648] 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 principals.[649] Futures brokers trading discretionary accounts are not required to provide contract notes to

646 ANZ *OTC Submission*, ABA *OTC Submission*, Coopers & Lybrand *OTC Submission*, AFMA *OTC Submission*, Westpac *OTC Submission*, Phillips Fox *OTC Submission*, SFE *OTC Submission*, Securities Institute of Australia *OTC Submission*, ISDA *OTC Submission*, Merrill Lynch *OTC Submission*, IBSA *OTC Submission*.

647 AFMA *OTC Submission*, Westpac *OTC Submission*, John O'Sullivan *OTC Submission*.

648 ss 1206, 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 Part 7.12 Divs 2 and 5: Corp Reg 7.4.02.

649 There is no need for an equivalent requirement for futures brokers, given the restrictions in s 1258.

those clients who have expressly waived their right.[650] Where more than one broker is involved, the obligation to provide a contract note rests on the last involved broker.[651]

7.78 Securities contract notes are standard,[652] whereas futures contract notes differ depending upon whether they relate to futures options,[653] eligible exchange-traded options[654] or one of the other types of futures contract.[655] The futures contract note provisions also apply to share ratio contracts.[656] Exchange business rules can supplement the contract note requirements for particular types of derivatives trading.[657]

7.79 The Advisory Committee supports the principle of there being contract note requirements for all on-exchange derivatives. However, it questions whether it is necessary to continue legislatively prescribing the contract note terms for each separate class of derivatives. This might more appropriately be left to financial exchange business rules. Respondents agreed.[658] Also, the power to disallow business rule amendments[659] could be exercised to ensure that contract note requirements for the same or similar classes of derivatives are consistent between financial exchanges.

OTC

7.80 The Advisory Committee considers that brokers who enter into OTC transactions as agents for their clients (whether wholesale or retail) should be obliged within a stipulated period to provide their clients either with a copy of the contract document or a contract note setting out the essential details of the transaction. That stipulated period should be determined through consultation with industry organisations.

7.81 By contrast, in principal-to-principal OTC derivatives contracts, the parties themselves should determine the method of confirming the terms of their contracts.[660] This is provided for in the standard ISDA documentation.[661] The Advisory Committee regards this documentation as satisfactory, even for retail counterparties. There should

650 s 1206(1)(b). Corp Regs Form 803C is the form of waiver agreement.

651 Corp Reg 8.4.01A.

652 s 842(3).

653 s 1206(4).

654 s 1206(5).

655 s 1206(3).

656 The effect of Corp Regs 1.2.06(a) and 1.2.10(1)(a) is that s 1206, rather than s 842, applies to share ratio contracts. This is reflected in ASX r 9.10.

657 eg ASX r 7.3.3.2 (options), SFE General By-law G.41(a).

658 ASX *On-exchange Submission*, SFE *On-exchange Submission*, RBA *On-exchange Submission*, BT *On-exchange Submission*.

659 cf ss 774, 1136.

660 ISDA *OTC Submission*, AFMA *OTC Submission*, Westpac *OTC Submission*, Phillips Fox *OTC Submission*.

661 The Merrill Lynch *OTC Submission* pointed out in practice it is not only customary for intermediaries to send a contract note or confirmation to all counterparties, but required by standard documentation used for OTC derivatives transactions.

be no statutory confirmation requirements. This would place Australian OTC derivatives markets at a competitive disadvantage.[662]

Contract notes

Recommendation 34.

On-exchange

The contract note requirements for each class of on-exchange derivatives should be determined by the business rules of any financial exchange on which they are traded.

OTC

Brokers who enter into OTC transactions as agents for their clients (whether wholesale or retail) should be obliged within a stipulated period to provide their clients either with a copy of the contract document or a contract note setting out the essential details of the transaction.

Protection of client assets

7.82 It is commonplace in the derivatives market (as with the securities market) for brokers to hold the assets of their clients. These assets may be held, for instance, as initial deposits or ongoing margin funds or for the operation of discretionary accounts. Brokers may also hold client assets in consequence of settling transactions on their behalf.

7.83 The Advisory Committee supports the internationally-held view that these assets should be protected in the interests of enhancing public confidence in financial markets.[663] Clients may not participate in the market if they consider that the risk of loss of their assets as a result of the fraud, carelessness, unclear responsibilities or insolvency of brokers who hold their assets is too high. Clients should have the confidence that, as far as possible, their assets will be properly handled and accounted for and will be quarantined in the event of the insolvency of their brokers.

7.84 Effective client protection requires rules relating to:

- periodic statements
- client funds
- client property.

7.85 These rules would be in addition to mandatory compensation arrangements covering defalcation or fraudulent misuse of client assets by on-exchange brokers.[664] The Advisory Committee does not propose comparable compensation arrangements

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662 ISDA *OTC Submission*.

663 IOSCO Technical Committee Report *Client Asset Protection* (August 1996).

664 paras 4.63-4.68, supra.

for the OTC derivatives market.[665] Instead, this difference would be drawn to the attention of OTC participants through the proposed risk disclosure statement.[666]

Periodic statements

On-exchange

7.86 Currently, futures brokers must send monthly statements to their clients where, during the preceding month, they have:

- held money or property on the client's account
- acquired a futures contract that has not been disposed of, or
- had the client's authority to operate a discretionary account.[667]

7.87 Matters covered by these statements include:

- the cash balance at the beginning and end of the month
- all credits and debits during the month
- a description of any futures contract acquired during, and still held at the end of, the month
- details of any outstanding deposit or margin calls.

7.88 Securities dealers are required to send similar monthly statements to their clients for dealings in share ratio contracts[668] or where there have been any options transactions (including LEPO transactions) in the preceding month.[669]

7.89 The Advisory Committee considers that the current statutory requirements for monthly statements are satisfactory and should apply to all on-exchange derivatives. These requirements could remain in the Corporations Law, given that they do not need to be tailored to each class of derivative contract. Any additional requirements could be stipulated in the business rules of a financial exchange. Respondents agreed.[670]

OTC

7.90 The Advisory Committee considers that an OTC derivatives broker should be obliged to furnish a monthly statement to a client (whether wholesale or retail) where:

- any money or other property (including any deposits lodged by the client with the broker against continuing liabilities under current or anticipated OTC derivatives contracts) is held for that client during that period

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665 paras 4.35-4.39, supra.

666 para 7.34, supra.

667 s 1207, as modified by various Corporations Regulations, including Corp Regs 8.4.03, 8.4.03A and 8.4.04.

668 Corp Reg 1.2.10(1)(a) and (2)(a). This is reflected in ASX rr 9.11, 9.12.3.

669 ASX r 7.3.3.4.

670 SFE *On-exchange Submission*, ASX *On-exchange Submission*, RBA *On-exchange Submission*, BT *On-exchange Submission*.

- any money is paid or received by the broker under any completed, closed out or continuing OTC derivatives contract to which the client is a principal during that period, or
- any fee or other charge is imposed by the broker during that period.

7.91 Similar reporting requirements apply overseas.[671] A requirement of this type was supported in submissions.[672]

Periodic statements

Recommendation 35.

On-exchange

On-exchange derivatives brokers should be required to send monthly statements to their clients where, during the preceding month, they have:

- held money or property on the client's account
- acquired a derivatives contract that has not been disposed of, or
- had the client's authority to operate a discretionary account.

OTC

An OTC broker should be obliged to furnish a monthly statement to a client (whether wholesale or retail) where:

- any money or other property (including any deposits lodged by the client with the broker against continuing liabilities under current or anticipated OTC derivatives contracts) is held for that client during that period
- any money is paid or received by the broker under any completed, closed out or continuing OTC derivatives contract to which the client is a principal during that period, or
- any fee or other charge is imposed by the broker during that period.

Client funds

On-exchange

671 Under UK Investment Management Regulatory Organisation (IMRO) r 4.5(6), a firm must provide a customer having uncovered open positions in derivatives with a report at least monthly in the case of a derivatives-only portfolio or quarterly in the case of a mixed portfolio of securities and derivatives. However, where the open derivatives positions exceed 20% of the value of the mixed portfolio, the report must be sent monthly rather than quarterly. IMRO Consultation Document 33 *Derivatives* (November 1996) para 2.22 proposed at least monthly reporting where a portfolio contains any uncovered open positions. In addition, the IOSCO Technical Committee Report *Client Asset Protection* (August 1996) recommends that all authorised firms (brokers) should be required to report on a regular basis to their clients concerning the assets that they hold on their behalf (Recommendation 3).

672 RBA *OTC Submission*.

7.92 *Separating dealers' from clients' funds.* Currently, securities dealers and futures brokers must separate client funds from their own funds. Client funds cannot be used to meet margin calls on proprietary trading by brokers, or otherwise be available to meet a broker's own debts.[673] This seeks to ensure that client funds are not available for distribution to creditors of an insolvent dealer or broker. The Advisory Committee notes that this obligation to separate funds complies with international best practice.[674] The same requirements should apply to exchange-traded derivatives.

7.93 *Accounting for client funds.* Currently, a securities dealer must maintain a trust account, and a futures broker a segregated account (sometimes referred to as an omnibus account), for clients' money.[675] The essential differences between these accounts are:

- the funds of each client are separately identified in a trust account but are commingled with all other clients' funds in a segregated account

- funds deposited by a client in a trust account cannot be used to meet the margin or settlement requirements of another client. By contrast, funds in a segregated account can be used in this manner.

7.94 Trust account arrangements, by separately identifying the funds of each client, protect individual clients from the defaults of other clients. However, these arrangements also reduce the funds available to brokers to meet any outstanding clearing house margin calls or settlement requirements. Conversely, the segregated account arrangements increase the funds available to brokers to meet these calls or requirements. Segregated accounts also facilitate current futures clearing house procedures.[676] However, individual clients may be disadvantaged if other clients default.

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673 ss 871, 1209(14)(a), SFECH By-law 41.7. For instance, each SFE clearing member has two segregated accounts at the clearing house: a clients' account for positions held by clients and a proprietary account for positions held by the clearing member in its own right. SFECH has access to any surplus in the proprietary account to reinstate the clients' account as far as possible. However, SFECH cannot draw from the clients' account to cover defaults in the proprietary account. ASX r 10.3.1.1 also requires the separation of broker and client accounts.

674 *Futures Industry Association Financial Integrity Recommendations* (June 1995) Recommendation 19. This practice would avoid the problem that arose in connection with the Barings collapse, where house and client funds were permitted to be intermingled with consequent difficulties and delays in reimbursing some clients of Barings. According to the Windsor Declaration (May 1995) made by the ASC and overseas regulators, the separate identification and holding by financial intermediaries of end-user positions, funds and assets plays an important role in customer protection and reducing the potential for systemic risk. The various ways to protect clients' funds from loss through dealer insolvency or misuse were further examined in the subsequent IOSCO Technical Committee Report *Client Asset Protection* (August 1996).

675 ss 866-869, ASX r 1.2.2 (trust account); s 1209(3)(c), (5), SFE art 43 (segregated account). The effect of Corp Regs 1.2.03 and 1.2.10 is that the trust account provisions, not the segregated account provisions, apply to trading in share ratio contracts.

676 *Explanatory Memorandum to the Futures Industry Bill 1986*, para 200: "The practices of the SFE ... make the trust account an impracticable method of protecting clients' money. The clearing house deals with the floor member on a principal to principal basis and makes no distinction between contracts of the floor member and contracts of the floor member's clients. Accordingly, when the clearing house calculates the deposit and margin calls with respect to any

7.95 The Advisory Committee considers that it should be left to the discretion of any financial exchange to determine the method of accounting for derivatives trading. Also, financial exchanges on which both derivatives trading and securities trading are permitted should determine whether segregated or trust accounts are used on its derivatives and securities markets, respectively. It should not be necessary for the same accounting system to be used for all transactions on that exchange. However, the capital backing requirements of any clearing house or the exchange fidelity fund requirements may need to take into account the consequences of using trust accounts or segregated accounts, respectively.

OTC

7.96 OTC derivatives brokers, like on-exchange brokers, should hold client funds separately from their own funds. The Advisory Committee considers that these funds should be held in a trust account which separately identifies the funds of each client, rather than a commingled segregated account.[677] A trust account better protects the funds of individual clients, whereas a segregated account is more appropriate where there is a clearing house. This obligation should apply to OTC derivatives brokers whether their clients are wholesale or retail.

7.97 Also, a party to any OTC derivatives transaction (whether or not a licensed intermediary) who receives any deposit or margining funds from its counterparty should be obliged to hold those funds in trust, unless both parties are wholesale participants and the terms of a particular OTC derivatives transaction or the relevant provisions of a Master Agreement stipulate some other arrangement.[678] Wholesale participants should have the capacity to settle these arrangements between themselves. Retail participants may lack the knowledge or bargaining power to properly protect their funds. However, any trust arrangements should be subject to any statutory priorities, for instance, under the Banking Act.[679]

Client funds

On-exchange

Recommendation 36. On-exchange derivatives brokers should be required to separate their clients' funds from their own funds.

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floor member, it has regard to the net position of all contracts registered with it by that floor member. When funds are paid by the floor member to the clearing house in response to deposit and margin calls it is not possible to trace funds received from any particular client as passing to the clearing house."

677 ASC *OTC Submission*, Phillips Fox *OTC Submission*, RBA *OTC Submission*, Westpac *OTC Submission* favoured the use of trust accounts.

678 Various submissions including IBSA *OTC Submission*, ISDA *OTC Submission*, Merrill Lynch *OTC Submission*, AFMA *OTC Submission* referred to the Credit Support Annexure to the ISDA Master Agreement which sets forth the rights of a party to hold, commingle or repledge any collateral.

679 AFMA *OTC Submission*.

Recommendation 37. It should be left to the discretion of any financial exchange to determine the method of accounting for derivatives trading. Also, financial exchanges on which both derivatives and securities trading take place should be permitted to determine whether segregated or trust accounts are used on their derivatives and securities markets, respectively. It should not be necessary for the same accounting system to be used for all transactions on a particular exchange.

OTC

Recommendation 38. OTC derivatives brokers should hold the funds of their wholesale and retail clients separately from their own funds in a trust account.

A party to any OTC derivatives transaction who receives any deposit or margining funds from its counterparty should be obliged to hold those funds in trust, unless both parties are wholesale participants and the terms of a particular OTC derivatives transaction or the relevant provisions of a Master Agreement stipulate some other arrangement.

Any trust arrangements should be subject to any statutory priorities.

Client property

On-exchange and OTC

7.98 Currently, on-exchange futures brokers are subject to two separate statutory requirements for holding client property. Brokers must hold in safe custody:

- property held to secure payment of margins under a futures contract.[680] This property is not available for the payment of any debt or liability of the broker[681]
- property designated for settling a physically deliverable futures contract, if requested by the client or provided for in the business rules.[682]

7.99 Securities dealers must hold clients' scrip in separate safe custody, if their clients so request.[683]

7.100 The Advisory Committee considers that there should be adequate procedures for identifying the property of any wholesale or retail client and protecting it against loss from proprietary derivatives trading by on-exchange and OTC intermediaries.[684] Client property should be held separately from the funds or assets of the broker. It should be held in separate safe custody, subject to any alternative arrangements

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680 s 1209(3)(d), (6).

681 s 1209(14). Also, SFECH By-law 41.7, which provides that money or property in a Client Clearing Account may not be used for the House Clearing Account.

682 s 1214(1).

683 s 873(3). If a client does not request that scrip be deposited in safe custody, the scrip must be registered: s 873(2), (4).

684 cf *Futures Industry Association Financial Integrity Recommendations* (June 1995) Recommendation 41.

permitted under the business rules of a financial exchange. Respondents agreed.[685] The Financial System Inquiry also favoured rules on handling client property and money.[686]

7.101 Also, a party to any OTC derivatives transaction (whether or not a licensed intermediary) who receives any property from its counterparty to secure deposit or margining obligations, or to be held pending settlement, should be obliged to hold that property in trust, unless both parties are wholesale participants and the terms of a particular OTC derivatives transaction or the relevant provisions of a Master Agreement stipulate some other arrangement. There should be no interference with the terms of Master Agreements, as they affect transactions between wholesale counterparties. Wholesale participants should have the capacity to settle these arrangements between themselves. Retail participants may lack the knowledge or bargaining power to properly protect their property.

Client property

Recommendation 39. On-exchange and OTC derivatives brokers should hold the property of their wholesale and retail clients separately from their own assets.

A party to any OTC derivatives transaction who receives any property from its counterparty to secure deposit or margining obligations, or to be held pending settlement, should be obliged to hold that property in trust, unless both parties are wholesale participants and the terms of a particular OTC derivatives transaction or the relevant provisions of a Master Agreement stipulate some other arrangement.

Records of clients' or counterparties' trading

7.102 Proper and separate record-keeping can ensure that the respective legal and financial position of intermediaries and clients can be identified and distinguished. It protects one party if the other becomes insolvent. For instance, it is common for liquidators of an insolvent broker to freeze the assets and any outstanding financial market positions of that broker. In the absence of rules requiring the separate identification of brokers' and clients' positions, it is likely that all these positions will be frozen. The separate identification of broker and client positions ensures that clients' transactions can be transferred or closed out speedily without interfering with the due administration of a broker's insolvency. This principle is recognised internationally.[687]

7.103 Separate record-keeping also aids in the resolution of any disputes. Likewise, it assists the regulator in its surveillance and enforcement functions.

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685 For instance, ASX *On-exchange Submission*, RBA *On-exchange Submission*, SFE *On-exchange Submission*, BT *On-exchange Submission*.

686 *Financial System Inquiry Final Report* Recommendation 15.

687 IOSCO Technical Committee Report *Client Asset Protection* (August 1996). Recommendation 19 supports arrangements to permit the separate identification of client and broker positions.

On-exchange

7.104 Currently, on-exchange brokers are under a statutory obligation to keep records of the orders received and transactions made on behalf of clients.[688] In addition, the exchanges require their members to maintain these records.[689]

7.105 The Advisory Committee considers that there should be a statutory record-keeping obligation for on-exchange brokers, supplemented, where appropriate, by exchange business rules. These requirements should ensure that the course of trading on behalf of clients can be fully reconstructed to provide a comprehensive audit trail. In addition, there should be a consistent period for keeping all records related to on-exchange derivatives and securities transactions. At present, accounting records, and all records lodged with the ASC, must be kept for seven years.[690] The Exchanges have similar record-keeping requirements.[691] Other records must be held for five years.[692] The Advisory Committee supports a uniform statutory seven year record-keeping period.

OTC

7.106 The Advisory Committee considers that OTC brokers should be under a statutory obligation to keep records in Australia of their wholesale and retail clients' OTC derivatives transactions. There should be audit trail obligations similar to those required for on-exchange derivatives brokers. Currently, the holder of an exempt OTC market declaration must maintain records of all transactions entered into on that market.[693]

7.107 Different rules should apply to OTC market-makers, depending on whether they are dealing with wholesale or retail end-users. Many submissions emphasised that parties in the wholesale market can contract for their own record-keeping requirements and that to impose any statutory obligation would be contrary to international practice.[694] By comparison, submissions supported requiring those OTC market-makers who deal with retail end-users to keep records of these transactions for seven years.[695] The Advisory Committee supports this regulatory distinction between wholesale and retail end-users.

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688 ss 856, 1213, 1266(7).

689 ASX rr 1.2.1, 7.3.2.5-7.3.2.8, 9.12.4, 9.15.2-9.15.5, SFE arts 3.6(3)(j), 4.6(4)(g), 4A.7A(4)(f). These obligations are consistent with international best practice: see *Futures Industry Association Financial Integrity Recommendations* (June 1995) Recommendations 41 and 43.

690 ss 1116(2)(b), 1270(2)(b). For records lodged with the ASC, see s 1116(5) and Corp Reg 7.14.01, s 1270(4) and Corp Reg 8.7.03.

691 See, for instance, ASX rr 7.3.2.7, 9.15.4.

692 ss 1116(2)(a), (3), 1270(2)(a), (3).

693 ASC Policy Statement 70 para 64(b).

694 ABA *OTC Submission*, IBSA *OTC Submission*, ISDA *OTC Submission*, AFMA *OTC Submission*, John O'Sullivan *OTC Submission*, Phillips Fox *OTC Submission*, BT *OTC Submission*, SFE *OTC Submission*.

695 IBSA *OTC Submission*, Phillips Fox *OTC Submission*.

Records of clients' or counterparties' trading

Recommendation 40.

On-exchange

On-exchange derivatives brokers should be required to keep records of the orders received and transactions made on behalf of their wholesale and retail clients for seven years.

OTC

OTC derivatives brokers should be required to keep records of the orders received and transactions made on behalf of their wholesale and retail clients for seven years.

OTC market-makers to retail end-users should be required to keep records of their transactions with these end-users for seven years.

Record of proprietary derivatives trading by on-exchange brokers

7.108 Currently, futures brokers and securities dealers must maintain separate records of trading they undertake on their own account (proprietary trading).[696] In addition, securities dealers, but not futures brokers, must maintain a separate register of their proprietary trading in quoted and other public company securities.[697] In consequence, only securities dealers must:

- maintain all relevant information on one register
- enter that information within specific time limits
- keep the register in a standardised prescribed form
- inform the ASC of where that register is kept.

7.109 The ASC has a specific power to inspect and take copies or extracts from the register.[698] The Commission may also provide a copy of the register to another party, where this is in the public interest.[699]

7.110 The Advisory Committee in its On-exchange Draft Report proposed that all on-exchange derivatives brokers should be obliged to keep a register of their derivatives transactions.[700] The Draft Report noted that a register:

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696 ss 1208(1), (2), 856(10)(b), (12).

697 Part 7.7. This requirement also applies to securities dealers entering into share ratio contracts on their own account: Corp Reg 1.2.03. The register of interests in securities is not a public register.

698 s 885.

699 s 887.

700 Part 7.7 applies to financial journalists. There is no equivalent in Chapter 8 of the Corporations Law. The *ASX Submission to the Federal Attorney-General on Share Ratios* (August 1994) argued (at para 17.1) that financial journalists should be required to disclose their interests in share ratios, given that these contracts would give them an equal stake (positive or negative) in the share price of the company concerned.

- would help determine whether brokers have complied with open position limits arising from any novation clearing
- may provide evidence of possible insider trading, frontrunning (brokers placing their own orders ahead of those of their clients) or other market manipulative practices, and
- would be consistent with sound internal risk management practices.

7.111 Some respondents supported this Recommendation.[701] However, one respondent queried whether any register requirements should apply except to those derivatives for which the insider trading rules should apply.[702] Also, another respondent argued that brokers already maintain this information in accounting and settlement systems which are open to exchange surveillance. The cost of maintaining a separate register would be considerable, for no significant regulatory benefit.[703]

7.112 The Advisory Committee considers that the proprietary trading of on-exchange derivatives brokers should be clearly identifiable and separately recorded in a form that permits the reconstruction of transactions to provide a comprehensive audit trail. This may not necessarily require a formal register.

Record of proprietary trading

Recommendation 41. Own account positions of on-exchange derivatives brokers should be clearly identifiable and separately recorded, whether or not in a separate formal register.

Discretionary accounts

7.113 Derivatives market participants may elect, for a variety of reasons, to request market intermediaries to make derivatives trading decisions on their behalf and without their further instructions or consent. This has the potential to impose major financial commitments on clients. For these reasons, additional rules are necessary to govern the exercise of the powers to manage these discretionary accounts.

Managing the accounts

On-exchange

7.114 The SFE has developed a detailed regime for regulating discretionary futures accounts managed by its members. Its requirements include:

- a member operating a discretionary account on behalf of a client must have an agreement with that client permitting the member to trade in futures or options contracts on an exchange market or exempt futures market at the

701 ASX *On-exchange Submission*, AARF *On-exchange Submission*.
702 SFE *On-exchange Submission*.
703 BT *On-exchange Submission*.

absolute discretion of the member and without further reference or approval by the client[704]

- the client agreement must permit the client to limit the member's discretion by reference to the markets to be traded, size of open position, number of futures or option contracts traded per day, the proportion of money or property lodged with the member to be used for deposits and other limitations agreed in writing[705]
- members must disclose their performance record in managing discretionary accounts and any actual or potential conflict of interest that may affect their discretionary trading[706]
- the client agreement must permit the client to instruct the member to vary any existing limitation on the member's discretion and to transfer any open position to a non-discretionary account, provided that the client has lodged with the member a non-discretionary client agreement form[707]
- the member must ensure that only approved registered representatives exercise discretion in respect of the client's account[708]
- the member must maintain a full and complete record of each exercise of the discretionary authority, showing the name of the client, the details of the futures contract, the date and time of the transaction being effected and the name of the registered representative placing the order[709]
- the member must ensure that the transactions effected in relation to a discretionary account are not excessive in size or frequency in view of the nature of the financial resources of the account and the market involved.[710]

7.115 The ASX also regulates discretionary accounts managed by its members.[711]

7.116 The Advisory Committee considers that the rules for managing these accounts are most appropriately matters for financial exchange business rules.

OTC

7.117 Currently, the UK provisions require that firms may operate discretionary accounts on behalf of private (retail) clients only if they have a formal agreement with the client. These agreements must be signed by the client in circumstances where the firm is satisfied that the client has had a proper opportunity to consider its terms. Client agreements for discretionary accounts must specify the extent of the discretion to be exercised by the firm.[712]

7.118 The UK Investment Management Regulatory Organisation (IMRO) has proposed modifications to these client agreement forms to ensure that customers are

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704 SFE General By-law G.45(a), First Schedule Part B cl 3.1.
705 SFE General By-law G.45(a), First Schedule Part B cl 3.2.
706 SFE Twenty Fourth Schedule.
707 SFE General By-law G.45(a), First Schedule Part B cl 3.3.
708 SFE General By-law G.45(b)(i).
709 SFE General By-law G.45(b)(ii).
710 SFE General By-law G.45(c).
711 ASX rr 3.4, 7.3.4, 9.12, 9.13.
712 See further CASAC Research Paper at 75-76.

clear about the type of commitment into which they are entering and to clarify the firm's authority to act on behalf of the client.[713]

7.119 The Advisory Committee considers that a similar client agreement requirement should apply to any licensee who operates a discretionary OTC derivatives account on behalf of retail end-users. The mandatory terms of these accounts should be determined in consultation with industry. Wholesale end-users should themselves settle the terms for operating any discretionary accounts on their behalf.

Suitability

On-exchange and OTC

7.120 Under the UK rules, a firm has an overriding duty to ensure that any transaction which it effects or arranges in the exercise of any discretion is suitable for the customer concerned.[714] The SFE also imposes a suitability rule for dealers who manage discretionary accounts.[715] This rule draws no distinction between wholesale and retail clients.

7.121 The Advisory Committee considers that a statutory suitability rule, based on the SFE precedent, should apply to any licensee operating an on-exchange or OTC derivatives discretionary account. This requirement should apply for the benefit of wholesale as well as retail end-users, given that trading decisions are being made on their behalf. The remedies for breach of this requirement should be similar to those for breach of the "know your client" rule.[716]

Discretionary accounts

Managing the accounts

Recommendation 42. OTC licensees should be prohibited from operating a discretionary account on behalf of an OTC retail end-user without an appropriate written and signed client agreement.

Suitability

Recommendation 43. On-exchange or OTC licensees who operate discretionary accounts should be required to have reasonable grounds for believing that any transactions which they effect or arrange in the exercise of their discretion are suitable

713 IMRO Consultation Document 33 *Derivatives* (November 1996) paras 2.9 ff.

714 IMRO r 3.1(1).

715 SFE By-Law G.32(a)(iii) provides that an exchange member may not operate a Managed Discretionary Account on behalf of a client unless "the Member has reasonable grounds for believing 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".

716 paras 7.62-7.63, supra.

for the wholesale or retail client concerned, in view of the facts that are known, or should reasonably be known, about the client's personal and financial situation.

Chapter 8. Other derivatives regulation

This Chapter deals with a range of regulatory issues applicable to on-exchange and OTC derivatives market participants, various proposed controls on derivatives market behaviour, and regulatory information-gathering and enforcement.

Derivatives activity disclosure

8.1 The Advisory Committee considers that the growth in the use of derivatives and other financial market instruments, and the speed with which these products can transform the risk profile of their users, have created an increasing need for more timely and comprehensive periodic disclosure of these transactions. The true financial positions of some major participants can be obscured for some time. This may undermine the ability of financial markets to adjust quickly to the implications of those participants using derivatives. It may also complicate the task of assessing counterparty credit risk in the OTC market. Aggregate data on the level of OTC derivatives market activity are also lacking.

8.2 There have been various Australian and overseas proposals to introduce greater derivatives activity disclosure.

Group of Thirty (G-30) (July 1993)

8.3 The G-30 Report recommended that financial statements by dealers and end-users should contain sufficient information about their use of derivatives to provide an understanding of the purposes for which transactions are undertaken, the extent of the transactions, the degree of risk involved, and how the transactions have been accounted for. Pending the adoption of harmonised international accounting standards, the following should be disclosed:

- information about management's attitude to financial risks, how instruments are used, and how risks are monitored and controlled
- accounting policies
- analysis of positions at the balance sheet date
- analysis of the counterparty credit risk inherent in these positions
- for dealers only, additional information about the extent of their activities in financial markets.[717]

Institute of International Finance (IIF) (August 1994)

8.4 The IIF has encouraged uniform international disclosure standards. It recommended that financial firms disclose in their annual reports:

- derivatives-related credit exposures

717 *Derivatives: Practices and Principles*, Report prepared by the Global Derivatives Study Group of the Group of Thirty, Washington DC (1993), rec 20.

- derivatives activity levels
- derivatives policies and practices as part of the overall risk management system.[718]

8.5 These disclosures would assist participants to assess their own, and their counterparties', relative derivatives activity levels and credit exposures.

Bank for International Settlements (BIS) (September 1994)

8.6 BIS noted the increased disparity between market participants' ability to assess their own financial risks and those of their counterparties on the same terms.[719] It suggested that, to reduce this information gap in OTC markets, financial institutions should adapt for public disclosure the information generated by their own internal risk management systems. This information should cover:

- market risks
- counterparty credit risks, and
- performance in managing those risks.

8.7 This new information would complement conventional accounting disclosures which could not be expected to capture a firm's risk disclosure characteristics in the manner, or at the speed, required for derivatives, where the risk profiles can change drastically in a short time.

8.8 This Report also stated that differences in the information about risk and risk management available to managers and to outsiders may lead to a misallocation of investment capital. It proposed that financial institutions publish information on:

- their current exposures to derivatives
- the potential for further exposure to risk, should market prices fluctuate significantly
- the extent to which revenues of an institution have been derived from derivatives market activities, and
- the volatility of derivatives-based revenues.[720]

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718 *Preliminary Framework for Public Disclosure of Derivatives Activities* (1994).

719 BIS observed that:
"Financial markets function most efficiently when market participants have sufficient information about risks and returns to make informed investment and trading decisions. However, the evolution of financial trading and risk management practices has moved ahead of the public disclosures that most firms make of information that is relevant for such decisions. As a result, a gap exists between the precision with which a firm's management can assess its financial risks and the information available to outsiders. This asymmetry of information can cause a mis-allocation of capital among firms and can also amplify market disturbances. During episodes of market stress, this lack of transparency can contribute to an environment in which rumours alone can cause a firm's market access and funding to be impaired."

720 *Public Disclosure of Market and Credit Risk by Financial Intermediaries* (1994).

Bank for International Settlements (BIS) (February 1995)

8.9 This Report considered concepts and monitoring techniques which would provide appropriate information for international comparison. The Report recommended that central banks should initiate the regular compilation of market activity statistics based on data from the principal participants in derivatives markets, in conjunction with those participants and the relevant supervisory authorities. The regular dissemination of these statistics could improve transparency in derivatives markets.

Australian Society of Corporate Treasurers (ASCT) Industry Statement (March 1995)

8.10 The ASCT Industry Statement stated that shareholders, end-users and other interested parties (for instance, analysts) should be better informed about a disclosing entity's use of derivatives, including its management practices and policies. To achieve this, it recommended that at least the following should be disclosed annually:

- the specific purposes for which derivatives are used, for example, hedging, trading or investment, and the extent of these transactions
- the accounting policies the entity applied when preparing and presenting the disclosing entity's financial statements and the consolidated financial statements. These should include policies relating to recognising and valuing derivatives
- the nature and types of on- and off-balance sheet financial risks to which the disclosing entity is exposed. These may include credit, market and liquidity risks
- any significant concentrations of credit risk, based, for instance, on the credit rating or investment grade of counterparties, regional or country risks, or currency risks
- the entity's policies in giving collateral, security and credit enhancement
- how the entity monitors and controls the risks, for example, credit approval procedures, setting authority limits and separation of duties
- the entity's financial controls, for instance spot audit checks and verifying transaction records.

8.11 There has been debate in Australia about whether the ASCT proposals are too prescriptive or unduly intrude on directors' responsibilities.

Australian Society of Certified Practising Accountants (ASCPA) (May 1995)

8.12 The ASCPA argued that disclosure of derivatives alone may not completely or accurately describe the true level of an entity's financial risks. There may be risks in not protecting one's position through derivatives.[721] To focus only on derivatives

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[721] An entity may be at risk if its loan capital is subject to a variable interest rate, or its contracts are written in a particular currency, without the offsetting protection of an interest rate or currency derivative respectively.

disclosure could overstate the level of risk from their use or fail to identify the risks associated with their non-use. To identify these hidden risks, an entity should disclose:

- financial risks not covered by derivatives, and
- the extent to which derivatives transactions exceed underlying risks, or
- a statement from directors and managers confirming that there is nothing to disclose on either of the first two counts (if that is the case).

8.13 The Advisory Committee acknowledges the ASCPA's view that, ideally, participants should disclose their failure to use derivatives where necessary. However, it may be impracticable to impose a statutory obligation of this nature.

Basle Committee/IOSCO Public Disclosure of the Trading and Derivatives Activities of Banks and Securities Firms (November 1995)

8.14 This Basle Committee and IOSCO Technical Committee Report encouraged banks and securities firms to improve disclosure practices by providing meaningful summary information, both qualitative and quantitative, about their trading and derivatives activities. Disclosure should provide a picture of the scope and nature of an institution's trading and derivatives activities, as well as information on the major risks associated with those activities, including credit risk, market risk and liquidity risk. Institutions should also disclose information on the actual performance in managing these risks, particularly with respect to exposure to market risk. In addition, disclosures should provide meaningful summary information on how trading and derivatives activities contribute to an institution's earnings profile.

8.15 Disclosures on risk exposures and on the means of managing those exposures should be consistent with the methodologies employed in internal risk measurement and performance assessment systems. This should help ensure that disclosure practices keep pace with innovations in risk management practices over time, particularly in areas undergoing rapid evolution, such as market risk, where an increasing number of institutions are introducing or developing further their value at risk methodologies.

AASB 1033/AAS 33 Presentation and Disclosure of Financial Instruments (December 1996)

8.16 These Australian Accounting Standards provide a consistent basis for the periodic disclosure of information about financial instruments, including derivatives, utilised by reporting entities, and the financial risks involved. The term "financial instrument" is defined to cover a wide range of items including such derivatives as options, interest rate swaps and forward foreign exchange contracts. The information to be disclosed includes:

- the nature, terms and conditions of the financial instrument
- the objectives for holding or issuing derivatives and the strategy for achieving these objectives

- exposure to interest rate risk and credit risk, net fair values of classes of financial assets and financial liabilities, and hedges of anticipated future transactions.

8.17 Commodity contracts are to be included in the disclosures when they are of a type which is normally settled other than by physical delivery in accordance with general market practice. The Standards require disclosure of derivative financial instruments that have traditionally been kept off-balance sheet.

8.18 The Standards encourage, but do not require, a discussion of management's policies for controlling the risk associated with financial instruments.

Advisory Committee view

8.19 The Advisory Committee supports moves towards greater periodic disclosure of on-exchange and OTC derivatives and other financial market transactions. These disclosures would better inform the market of the purposes and extent of the transactions that reporting entities undertake, and the risks involved. Periodic disclosure could include, for instance, information concerning counterparty credit risk, marking-to-market and value at risk.[722]

8.20 The continuous disclosure requirements of the Corporations Law, which apply to listed and unlisted disclosing entities, may oblige particular entities to disclose their derivatives trading activities.[723] These disclosures would cover the time between their periodic reports. The Advisory Committee's *Report on Continuous Disclosure* (November 1996) supports the continuous disclosure regime and contains some recommendations to streamline its application and otherwise improve its effectiveness.

8.21 The Advisory Committee notes that AASB 1033 and AAS 33 only apply to "reporting entities" as defined in the Standards. Likewise, the continuous disclosure regime only applies to listed and unlisted "disclosing entities", as defined in Part 1.2A of the Corporations Law. The Advisory Committee in its OTC DP raised for consideration whether, for the purpose of derivatives disclosure, all wholesale participants should be deemed to be reporting and disclosing entities under AASB 1033/AAS 33 and the continuous disclosure provisions, respectively.

8.22 Some submissions supported extending the definitions to cover all derivatives activities of wholesale participants.[724] This would support market stability by ensuring that all these participants are subject to uniform disclosure requirements.

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722 The *AFMA Manual* Section 6 Chapter 2: Qualitative and Quantitative Disclosure summarises international practice and the exposure document for AASB 1033/AAS33 on each type of disclosure.

723 Disclosure of derivatives trading would be required if that activity came within the disclosure requirements in ASX Listing Rule 3.1 (for listed disclosing entities) or s 1001B(1) (for unlisted disclosing entities).

724 ANZ *OTC Submission*, RBA *OTC Submission*, Westpac *OTC Submission*, Treasury (formerly Attorney-General's Department) *OTC Submission*.

8.23 Other submissions opposed any extension of the definitions of reporting entities and disclosing entities merely for derivatives trading.[725] They argued that applying the extended definitions only to derivatives transactions could be inequitable and misleading. The extended definitions could also lead to duplication of reporting within corporate groups. Furthermore, the number of non-reporting and non-disclosing wholesale participants is likely to be small. Their failure would have little effect on the derivatives market.

8.24 The Advisory Committee agrees with those respondents who opposed extending the reporting entity and disclosing entity definitions. It considers that AASB 1033/AAS 33 and the continuous disclosure regime should not impose different disclosure requirements for derivative and other financial market transactions.

Marking derivatives to market

8.25 Marking-to-market is a valuation technique for reflecting the current value of financial instruments, including derivative contracts. It involves the revaluation of open positions in these contracts at current market prices and the calculation of any gains or losses that have occurred since the last valuation.

On-exchange

8.26 Currently, all exchange-based derivatives transactions that are subject to novation clearing are marked-to-market, at least daily, under clearing house margining arrangements. These arrangements seek to ensure that participants can continue to meet their obligations in the face of any adverse price movements.

8.27 The Advisory Committee supports financial exchanges having responsibility for setting and applying these margining rules.

OTC

No mandatory requirement

8.28 There is no equivalent marking-to-market procedure in the OTC derivatives market. Also, there is no universally accepted marking-to-market or other valuation methodology for participants in that market.

8.29 Accurate marking-to-market may be difficult in the OTC context as:

- OTC products lack centralised markets, such as exchanges, where prices are readily determined and disclosed.[726] Accurate valuation may not be

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725 IBSA *OTC Submission*, ISDA *OTC Submission*, AFMA *OTC Submission*, ASC *OTC Submission*, ASCT *OTC Submission*, John O'Sullivan *OTC Submission*, SFE *OTC Submission*, AARF *OTC Submission*.

726 AFMA *OTC Submission*, IBSA *OTC Submission*, AARF *OTC Submission*.

possible in illiquid OTC markets or for some highly customised transactions

- a complex interaction of factors can affect the measurement of market prices for some OTC products[727]
- valuations may involve the use of estimates.[728] It is possible to produce, in good faith, a range of values, due to different valuation models and other assumptions.[729]

8.30 Frequent marking-to-market may be unnecessary for certain types of OTC derivatives, for instance loan caps or hedged OTC transactions.

8.31 The Advisory Committee considers that there should be no statutory mark-to-market obligations for OTC derivatives market transactions. Instead, the process and frequency of marking-to-market should be an element of risk management systems employed by participants in that market. Most submissions to the OTC DP opposed any statutory direction on the frequency of marking-to-market.[730]

Public disclosure of mark-to-market information

8.32 The Advisory Committee has considered whether OTC market-makers, or other OTC wholesale participants, should be obliged to disclose publicly mark-to-market valuations of derivatives transactions, where marking-to-market is possible.

8.33 Submissions generally opposed this disclosure.[731] They argued that:

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727 For instance, the value of a portfolio of foreign exchange options may be affected by changes in exchange or interest rates and the length of time remaining before the option expires. All these factors would need to be taken into account when a product is priced. Also, the AFMA *OTC Submission* pointed out that mark-to-market can differ according to its purpose. For instance, for credit purposes, the assumption is replacement of the lost transactions, whereas for trading purposes, the assumption is rapid liquidation of existing contracts.

728 ABA *OTC Submission*.

729 IBSA *OTC Submission*, ISDA *OTC Submission*.

730 Many submissions opposed the OTC DP proposal that marking-to-market be required at least daily, or more frequently where changes in market conditions materially affect the existing valuation: AFMA *OTC Submission*, ASC *OTC Submission*, ASCT *OTC Submission*, ANZ *OTC Submission*, ABA *OTC Submission*, IBSA *OTC Submission*, ISDA *OTC Submission*, JP Morgan *OTC Submission*, Phillips Fox *OTC Submission*, Treasury (formerly Attorney-General's Department) *OTC Submission*, Securities Industry Association *OTC Submission*, SFE *OTC Submission*, Merrill Lynch *OTC Submission*, Westpac *OTC Submission*. Reasons given were:

- mark-to-market, if required, should only take place as often as appropriate (for instance, for loan caps, daily mark-to-market is inappropriate)
- a single valuation period cannot be mandated for all classes of participants and transactions: it may be appropriate for some end-users to value transactions less than daily
- it is sometimes difficult, depending upon the particular market, to obtain necessary valuation data on a daily basis
- the frequency of marks logically depends on the size, nature and sophistication of each transaction.

731 ASC *OTC Submission*, ASCT *OTC Submission*, ANZ *OTC Submission*, ABA *OTC Submission*, IBSA *OTC Submission*, ISDA *OTC Submission*, Merrill Lynch *OTC Submission*, Phillips Fox

- the continuous disclosure regime will require disclosure of significant changes in the position of disclosing entities. There is no compelling argument for an additional derivatives-specific mark-to-market disclosure regime
- public disclosure of mark-to-market valuations could involve commercially sensitive information
- these valuations would be meaningless or misleading without disclosure of valuation methods and underlying assumptions
- mark-to-market information would be incomplete unless it took into account the value of all other related financial markets transactions and the underlying asset/risk being hedged
- public disclosure may be misleading, as a mark-to-market valuation does not necessarily indicate a price at which a derivatives transaction can be completed or closed out, particularly for highly customised transactions in an illiquid market
- given that there is no international precedent, the proposal would unnecessarily place the Australian OTC derivatives market at a competitive disadvantage.

8.34 The Advisory Committee agrees. It considers that any public disclosure of summary information of mark-to-market valuations, and the frequency of this disclosure, should be determined by accounting standards.[732] The Advisory Committee also notes industry initiatives for participants to disclose fair value in their annual financial statements.[733]

Disclosure of mark-to-market information to OTC counterparties

8.35 The Advisory Committee has also considered whether OTC market-makers or other OTC wholesale participants should be required to disclose mark-to-market information to their counterparties, where marking-to-market is possible. Submissions did not support this obligation.[734] They gave the following reasons.

- A disclosure requirement for market-makers could transfer risk management responsibilities from counterparties to the market-maker. It may also discourage counterparties from developing their own methods for valuing OTC derivatives transactions.
- Imposing a mandatory disclosure requirement may undermine the competitive position of the Australian OTC derivatives market.
- End-users who lack skills to value their own derivatives transactions periodically can employ risk consultants or other advisers who offer mark-to-market or valuation services.

OTC Submission, Westpac *OTC Submission*, AFMA *OTC Submission*, John O'Sullivan *OTC Submission*.

732 See further paras 8.1-8.24, supra.

733 *AFMA Manual* Section 6 Chapter 2 Recommendation 6.

734 For instance, ANZ *OTC Submission*, ASC *OTC Submission*, IBSA *OTC Submission*, ISDA *OTC Submission*, JP Morgan *OTC Submission*, AFMA *OTC Submission*, John O'Sullivan *OTC Submission*, Securities Industry Association *OTC Submission*, SFE *OTC Submission*.

- The parties to derivatives transactions could negotiate the degree, frequency and cost of any arrangement by which one party periodically provides mark-to-market information or valuation prices to the counterparty.
- Any disclosure obligation would interfere with the concept of derivatives transactions being at arm's length and participants being thereby responsible for their own trading decisions.

8.36 The Advisory Committee agrees. To require all participants to be responsible for their own marking-to-market would be consistent with overseas practice that market-makers are not obliged to provide periodic valuations to counterparties. This applies even where the instrument sold is a proprietary product of the intermediary for which market valuations are neither publicly available nor readily ascertainable.[735] It is for the parties to determine in their contractual arrangements whether valuations will be provided, and under what conditions.

8.37 Persons providing mark-to-market or other valuation information to a counterparty, either voluntarily or as required under the terms of an agreement, should exercise good faith in determining valuations for OTC derivatives transactions. They should not prepare or communicate valuations with a view to misleading the counterparty. These counterparties would have remedies in contract or tort for any misleading or deceptive conduct by the provider.[736] Providers might protect themselves against common law claims for misrepresentation by clarifying the nature of the valuation (including the method of valuation and the underlying assumptions) and should consider indicating, where appropriate, that valuations may vary from firm to firm and are only indicative price quotations.[737]

Buy-out or exit price

8.38 The Advisory Committee has also considered whether OTC market-makers should be required to provide, upon request, and at a reasonable fee, a buy-out or exit price to their counterparties. The Committee considers that market-makers should be encouraged (rather than required) to provide this information, and notes industry support for this practice.[738] However, some further protection might be required for retail end-users. The Committee considers that, given that to terminate an OTC transaction typically requires the consent of the counterparty, an OTC market-maker dealing with a retail end-user should be obliged (for a reasonable price if required) to indicate to the retail end-user at the outset of the derivatives transaction whether or not

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735 United States *Principles and Practices for Wholesale Financial Market Transactions* (August 1995).

736 John O'Sullivan *OTC Submission*.

737 Merrill Lynch *OTC Submission*, AARF *OTC Submission*.

738 *AFMA Manual* Section 6 Chapter 4 para 3.4. The Manual states: "Clearly such a service has a price and Members are not necessarily expected to provide the service free of charge. The requirement to provide buyout prices for complex or structured transactions is greater than for ‘vanilla’ transactions (where revaluations and exit prices can be ascertained from a number of sources". The ABA *OTC Submission* pointed out that an exit costing would provide current information about the gain/loss position, which could be more useful than a calculation of a transaction's mark-to-market value.

the market-maker undertakes to buy back the contract, at the request of the retail end-user, prior to its completion.

Marking-to-market and buy-backs

Recommendation 44. There should be no statutory marking-to-market obligations in the OTC derivatives market. However, an OTC market-maker dealing with a retail end-user should be obliged (for a reasonable price if required) to indicate to the retail end-user at the outset of the transaction whether or not the market-maker undertakes to buy back the contract, at the request of the retail end-user, prior to its completion.

Prospectus disclosure

On-exchange and OTC

8.39 The Advisory Committee, in its On-exchange Draft Report, proposed that the prospectus requirements not apply to either on-exchange or OTC derivatives transactions. Submissions generally agreed.[739] Prospectus obligations currently apply to primary issuers of securities (including options issued by a company permitting the taker to subscribe for the company's unissued shares[740]), but not derivatives. The value of these securities depends heavily on the performance and prospects of the issuer's business, as known to, and described by, that issuer in the prospectus. By contrast, the value of a derivative arises from some other asset or index. Relevant information is not in the unique possession of the issuer of the derivative.

8.40 The Advisory Committee, in its OTC DP, raised the issue whether there should be any specific statutory obligation on collective investment schemes issuing prospectuses to provide derivatives-specific information, such as:

- the capacity of the scheme manager (responsible entity) to enter into derivatives transactions
- the extent of any restrictions on that power, and
- the methods of ensuring compliance with any restrictions.

8.41 There was considerable support for this information being publicly available.[741] However, the Advisory Committee has recommended in another Report that these matters be set out in the constitution of a collective investment scheme.[742] This should include any capacity to enter into derivatives transactions. Also, scheme managers must disclose in their prospectuses details of their investment policies, including those

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739 ASC *OTC Submission*, Treasury (formerly Attorney-General's Department) *OTC Submission*, AFMA *OTC Submission*, ANZ *OTC Submission*, ABA *OTC Submission*, Coopers & Lybrand *OTC Submission*, IBSA *OTC Submission*, ISDA *OTC Submission*, Merrill Lynch *OTC Submission*, Phillips Fox *OTC Submission*, Westpac *OTC Submission*, John O'Sullivan *OTC Submission*, Securities Industry Association *OTC Submission*, AARF *OTC Submission*, SFE *OTC Submission*.

740 The ASC and SFE *OTC Submissions* favoured a prospectus for these options.

741 ANZ *OTC Submission*, Phillips Fox *OTC Submission*, RBA *OTC Submission*, Westpac *OTC Submission*, AFMA *OTC Submission*, AARF *OTC Submission*.

742 ALRC/CASAC Report, *Collective Investments: Other People's Money* (1993) vol 1 at para 4.5.

relating to derivatives.[743] The Advisory Committee considers that this suffices to ensure that all relevant information is available to investors.[744] No further specific provision is required.

Controls on marketing

8.42 The free flow of accurate information about derivatives products assists market participants to make better informed trading decisions. Some marketing controls may be necessary to ensure that participants are not subject to undesirable advertising that contains false or misleading information. Equally, retail participants may need to be protected against pressured selling methods that may lead them to make hasty and ill-advised derivatives trading decisions.

On-exchange and OTC

8.43 Currently, the ASC may control undesirable advertising by prohibiting any person (whether or not a licensee) from publishing or broadcasting statements concerning futures contracts or futures broking or advising businesses.[745] The exchange rules also impose controls on marketing futures contracts, including cold calling.[746]

8.44 There is no equivalent ASC power for those derivatives that currently are securities, other than for share ratio contracts.[747] However, all those derivatives are subject to statutory controls dealing with:

- misleading or deceptive conduct,[748] and
- false or misleading statements or information that could induce persons to enter into securities transactions.[749]

8.45 The Advisory Committee considers that the same undesirable advertising and market controls should apply to all on-exchange derivatives transactions. Respondents agreed.[750]

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743 Corp Reg 7.12.12.

744 Corrs *OTC Submission*, John O'Sullivan *OTC Submission*, SFE *OTC Submission*, ISDA *OTC Submission* considered that the current law in s 1022 was sufficient to ensure this disclosure and that it was undesirable to return to a "check list" approach.

745 s 1205, ASC Policy Statement 114. The ASC may not make a prohibition order without first giving the affected person an opportunity for a hearing.

746 SFE art 3.6(3)(p) contains a general prohibition on members engaging in any advertising that may be false or misleading or prejudicial to the goodwill and public image of the Exchange. Also, SFE art 3.6(3)(q) prohibits a member from issuing any unsolicited written business communications to non-clients, other than listed companies, without the written approval of the SFE Committee for Inspection and Audit.

747 Corp Reg 1.2.10(1)(a) applies s 1205 to share ratio contracts. In addition, ASX r 9.7.4 requires clearing members who advertise investment in share ratio contracts to disclose the risks associated with those contracts. Also, there are restrictions on advertising those securities that are subject to a prospectus: ss 1025, 1026.

748 s 995. The Committee notes that s 995 has been applied to deliverable share futures: Corp Reg 1.2.23.

749 ss 999, 1000.

8.46 Equivalent undesirable advertising and market controls should also apply to all OTC derivatives.[751] Submissions supported this approach.[752] These controls would reduce the need for other regulatory controls over principal-to-principal transactions in the OTC market.[753]

Cold calling

8.47 The Advisory Committee has considered whether there should be any controls over unsolicited approaches to end-users (cold calling). Submissions did not support any restriction in the wholesale market.[754] This would unnecessarily limit competition in that market and could disadvantage wholesale end-users. Wholesale participants should be able to assess the value of the service or product offered.

8.48 The Advisory Committee considers that any cold calling restrictions should be limited to the retail market. To regulate against possible "boiler room" selling methods or other undesirable practices, persons could be prohibited from inducing or attempting to induce, through unsolicited contact, any retail person to enter into any on-exchange or OTC derivatives transaction, unless they hold a financial markets licence, a term of which permits them to cold call retail end-users.[755] The ASC could impose conditions on any licence which permits cold calling. These conditions could include, for instance, a cooling off period or a dispute resolution requirement. These powers would be in addition to the ASC's controls over undesirable derivatives advertising.

Cross-border marketing

8.49 The Advisory Committee recognises that there is considerable scope for marketing derivatives products internationally, particularly on the Internet. It considers that, in principle, the ASC should have the power to control any form of undesirable derivatives advertising or other promotional activity directed at persons located in Australia, regardless of the source's location. The ASC has recognised the difficulties in enforcing Australian law fully in relation to persons located in overseas jurisdictions who provide information or advice on the Internet.[756] To overcome this difficulty, the Advisory Committee supports the principle of the ASC working closely with overseas regulators to protect the interests of Australian derivatives market participants.

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750 SFE *On-exchange Submission*, ASX *On-exchange Submission*, RBA *On-exchange Submission*, BT *On-exchange Submission*, AARF *On-exchange Submission*.

751 Compare ss 995, 999 and 1000.

752 Phillips Fox *OTC Submission*, Treasury (formerly Attorney-General's Department) *OTC Submission*, ASC *OTC Submission*, AARF *OTC Submission*.

753 SFE *OTC Submission*.

754 ANZ *OTC Submission*, AARF *OTC Submission*, John O'Sullivan *OTC Submission*, Phillips Fox *OTC Submission*.

755 The UK Securities and Futures Authority r 5-10(2) prohibits "direct offer advertisements", that is, advertisements which invite recipients to respond by committing themselves to deal, or make use of the investment services of the advertiser.

756 cf ASC Policy Statement 118.58.

Controls on marketing

Recommendation 45. The ASC should have a power to control undesirable derivatives advertising by prohibiting a person from publishing or broadcasting statements concerning on-exchange or OTC derivatives contracts or derivatives broking or advising businesses.

There should be controls over:

- misleading or deceptive conduct in relation to on-exchange or OTC derivatives contracts
- false or misleading statements or information that could induce persons to enter into on-exchange or OTC derivatives contracts.

Persons should be prohibited from inducing or attempting to induce, through unsolicited contact, any retail person to enter into any on-exchange or OTC derivatives transaction, unless they hold a financial markets licence, a term of which permits them to cold call retail end-users.

The ASC's controls on marketing should extend to cross-border marketing.

Offences

8.50 The economic efficiency of financial markets depends on the timely and accurate flow of information to those markets and the avoidance of practices that interfere with their price discovery function. For instance, economic inefficiencies in a derivatives market may arise if trading occurs at artificial or distorted prices. These inefficiencies may also occur in a physical market in the underlying of the corresponding derivatives market.

On-exchange

8.51 In general, the current securities and futures provisions of the Corporations Law have similar rules governing improper conduct.[757] The Advisory Committee considers that the principles that currently apply to futures trading[758] should apply to all on-exchange derivatives transactions,[759] subject to the following reforms.

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757 Part 7.11 Divs 1 and 2, Part 8.7. However, there is no equivalent in Chapter 7 of s 1264, which is a specific offence of fraud in connection with dealings in futures contracts. JS Currie in *Australian Futures Regulation* (Longman Professional, 1994) notes (at 236) that "bucketing" of orders (failure of a broker to comply with a client's instructions to execute trades on-exchange), "frontrunning" (brokers placing their own orders ahead of their clients' orders) and "churning" (deliberate excessive trading) could fall within s 1264(d) (deceptive and misleading conduct) and may in certain circumstances constitute futures fraud under s 1264(c) (defrauding a client).

758 Part 8.7.

759 The ASX, in its *Submission to the Federal Attorney-General on Share Ratios* (August 1994) stated (at para 11.1) that the Chapter 8 provisions concerning futures market manipulation, false trading and market rigging (ss 1259, 1260) are more appropriate for share ratio contracts than the Chapter 7 provisions (ss 997, 998). The Part 8.7 offence provisions generally apply to share

Insider trading

8.52 The insider trading prohibition in Part 8.7 Div 1 applies only to insider trading in equity futures, and only for restricted categories of persons, namely anyone connected with a body corporate and other persons associated with that connected person.[760] In its On-exchange Draft Report, the Advisory Committee proposed that:

- the categories of insiders should be widened to include all persons in possession of inside information[761]
- the prohibition on insider trading be applied to derivatives based on commodities as well as securities.[762]

8.53 There was general support in submissions for the category of insiders not being limited to connected persons, but being widened in the manner proposed by the Advisory Committee.

8.54 One argument for extending the insider trading provisions to exchange-traded derivatives over commodities is that otherwise the efficient price discovery mechanism of that market could be distorted by uncertainty about whether parties are trading on the basis of confidential price sensitive information.

8.55 However, some respondents opposed extending the insider trading prohibition beyond derivatives over equities.[763] They pointed out that the prohibition on insider trading of derivatives over equities supports the prohibition on the insider trading of the underlying equities themselves. However, to extend the insider trading provision to derivatives over commodities would prohibit a person from buying or selling derivatives over a commodity (when in possession of confidential price-sensitive information concerning that commodity), although that person could still lawfully buy or sell the physical commodity itself. In consequence, the insider trading prohibition would apply to the derivative, but not to its underlying.

8.56 The Advisory Committee accepts these arguments for not extending the insider trading prohibition to derivatives based on commodities.

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ratio contracts (Corp Reg 1.2.10(1)(b)), though Corp Reg 1.2.05 also applies ss 997 and 1001 to share ratio contracts. Section 998 (in addition to Part 8.7) has been applied to deliverable share futures contracts: Corp Reg 1.2.23.

760 The futures contract must concern a body corporate (s 1251). Also, the categories of insiders are confined to persons connected with a body corporate (s 1252) and other persons associated with that connected person (ss 1253(3), 1254).

761 cf 1002G.

762 This change would cover, for instance, an executive of a large mining company who takes a short position in gold futures contracts on the basis of confidential information about the discovery of a major gold deposit, in the knowledge that the increased supply of gold from this discovery is likely to cause the price of gold futures contracts to fall: S Ansell, "The Regulation of Insider Trading in Derivatives" (1995) 13 *Company and Securities Law Journal* 476 at 480. Arguably, this would be outside the Chapter 8 insider trading provisions, as it is a futures contract over a commodity not a security.

763 SFE *On-exchange Submission*, Michael Hains *On-exchange Submission*.

8.57 The Advisory Committee has also considered whether the insider trading provisions should apply to options and warrants over equity indices. It notes the argument that there is little likelihood that insider trading in those derivatives could occur.[764] However, insider trading could take place through "mirror trades", that is where an insider buys a derivative on an aggregate share index and sells short the shares in individual companies covered by that index, other than the company about which the insider has inside information. This is equivalent to having directly bought shares in that company. For this reason, the insider trading prohibition should apply to all equity derivatives, including index options and index warrants.

8.58 The securities insider trading provisions, amended in 1991,[765] would be an appropriate precedent for the derivatives insider trading provisions. The derivatives provisions should cover insider trading in related derivatives and physical markets, for instance a broker trading in one market before executing a known price sensitive order for a client in a related market. Adopting the Chapter 7 securities model would also give the derivatives insider trading provisions extra-territorial application.[766]

Market manipulation

8.59 Any legislation to control market manipulation must take into account that:

- derivatives markets are interlinked with physical markets, and
- derivatives trading is increasingly cross-border.

8.60 The existing market manipulation provisions[767] may need amendment to fully cover these factors.

8.61 Chapter 8 of the Corporations Law prohibits transacting on a physical market to manipulate a futures market, and improper trading on a futures market.[768] These Chapter 8 provisions should be applied to all on-exchange derivatives trading, and be extended to prohibit improper transacting in derivatives contracts to manipulate a physical market.

8.62 The Australian market manipulation provisions should cover any off-exchange securities or derivatives activities conducted in Australia or offshore that are directed at manipulating a market in derivatives or securities conducted by an Australian financial exchange. Likewise, these Australian laws should cover any off-exchange securities or derivatives activities in Australia that are directed at manipulating a

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764 HAJ Ford, RP Austin & IM Ramsay, *Ford's Principles of Corporations Law* (Butterworths, loose-leaf) at [9.650].

765 Part 7.11 Div 2A.

766 Part 8.7 has no extra-territorial application, given s 110D. This contrasts with Chapter 7 of the Corporations Law which applies to acts or omissions outside Australia in relation to securities of a body corporate formed or carrying on business in Australia (s 1002).

767 ss 997, 998 (securities), 1259, 1260 (futures).

768 ss 1259, 1260.

foreign derivatives or physical market. Submissions supported this extension of the market manipulation provisions.[769]

8.63 The ASC could enforce cross-border market manipulation provisions through mutual assistance arrangements, and exchanges of information, with foreign regulators.[770]

Bucketing

8.64 Bucketing involves the failure of a broker to comply with a client's instructions to execute trades on-exchange. Currently, this practice is prohibited by the general requirement that futures contracts must be traded on-exchange.[771] The Advisory Committee elsewhere recommends a different on-exchange rule for derivatives.[772] Bucketing by derivatives brokers should be prohibited by other provisions, such as a prohibition on fraud in connection with dealings in any derivatives contracts.[773]

Frontrunning

8.65 The current securities and futures provisions impose restrictions on exchange brokers giving priority to their own orders over client orders.[774] However, only the futures frontrunning provision regulates the sequence of dealing between client orders.

8.66 The Advisory Committee supports the frontrunning principles being applied to all exchange-traded derivatives. However, the frontrunning provision should prohibit all conflicts of interest between brokers and clients and ensure market confidence. The futures frontrunning provision is generally more appropriate for derivatives, given that it regulates the sequence of dealing between client orders as well as prohibiting brokers from giving priority to their own orders.[775] However, the provision may need some amendment to ensure that it properly reflects contemporary broking practice. For instance, it only applies where instructions for orders are transmitted to the floor. It does not, but should, cover dealers' discretionary trading accounts which do not involve these transmissions. Also, the provision applies only where the client's instructions are to deal in a futures contract at or near the current market price. It should also cover those circumstances where the client's instructions are to deal in a derivative at a price that differs from the market price, for instance under a stop loss

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769 For instance, RBA *On-exchange Submission*, ASX *On-exchange Submission*, BT *On-exchange Submission*.

770 The US Commodity Futures Trading Commission Report *International Regulation of Derivative Markets, Products and Financial Intermediaries* (1996) emphasises the need for increased cross-jurisdictional communication and co-operation to reduce fraud or manipulation in the markets of one jurisdiction through transactions in other jurisdictions.

771 s 1258.

772 Recommendation 8.

773 cf s 1264.

774 ss 844 (securities), 1266 (futures). See also ASX rr 5.6, 7.3.2, 9.14.2.

775 ASX rr 9.14, 9.15 cover sequence of dealing between client orders in relation to share ratio contracts.

order.[776] The frontrunning provision would be in addition to exchange-based dual trading rules.[777]

8.67 Respondents supported reforms to the frontrunning provisions to take into account contemporary practice.[778]

OTC

8.68 Currently, only some OTC derivatives market transactions are subject to the market manipulation and other improper conduct offence provisions in the Corporations Law. For instance, transactions that take place on an exempt futures markets are subject to the market manipulation provisions of Part 8.7.[779] By contrast, all transactions that are specifically exempt from the definition of futures contract[780] are outside these provisions.

8.69 The Advisory Committee considers that insider trading and market manipulation offences, similar to those proposed for on-exchange derivatives markets, should also apply to the OTC derivatives market. However, these provisions should ensure that accepted OTC practices, such as price and liquidity support structures and issuer buy-back of fixed interest securities, are not affected. There should be further consultation with industry bodies to settle this matter.

Offences

Recommendation 46. The on-exchange derivatives offence provisions should be based on those in Part 8.7 of the Corporations Law, with the following amendments:

- the insider trading rules should be based on those for securities in Part 7.11 Div 2A (rather than Part 8.7 Div 1) and should relate only to derivatives over securities
- the market manipulation provisions should specifically apply to any:
  - trading on any derivatives market to manipulate an underlying Australian physical market
  - trading on any underlying physical market to manipulate an Australian derivatives market

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776 These, and other, possible technical problems with s 1266 are discussed in JS Currie, *Australian Futures Regulation* (Longman Professional, 1994) at 147, A Ventura, "Frontrunning in the futures market" Vol 4 No 1 *Australian Corporate Lawyer* (May 1994) at 16, S Ansell, "The Regulation of Insider Trading in Derivatives" (1995) 13 *Company and Securities Law Journal* 476, J Carley, "The Future of Frontrunning" (1995) 13 *Company and Securities Law Journal* 434.

777 The SFE has specific By-laws and related Trading Etiquette rules to counter frontrunning: By-laws G.8(c), G.10(ca), (cb), G.10A, Trading Etiquette 12.2. Compare the US Commodity Futures Trading Commission rules regulating dual trading: Vol 25 *Securities Regulation Law Report* (1993) at 1062-1078.

778 SFE *On-exchange Submission*, ASX *On-exchange Submission*, RBA *On-exchange Submission*, BT *On-exchange Submission*.

779 ASC Policy Statement 70 paras 17. The ASC will impose conditions on an exempt futures market declaration to this effect: s 64(e).

780 s 72(1)(d).

  - trading on any Australian derivatives market or underlying physical market to manipulate a foreign market
- the current controls over frontrunning should be reformed to ensure that they take into account contemporary broking practice.

There should be similar OTC insider trading and market manipulation offence provisions, modified to take into account accepted OTC practices.

Short selling

8.70 In the securities market, short selling refers to persons selling securities that they do not yet own. Short selling is permitted for some classes of on-exchange securities, subject to various controls.[781] The question arises whether there should be any short selling rules for any derivatives market.

On-exchange

8.71 The Advisory Committee considers that the short selling rules for securities exchanges (the continued appropriateness of which is a question in its own right) cannot sensibly be applied to those on-exchange derivatives transactions which must be settled by cash adjustment rather than by physical delivery.[782]

8.72 The short selling rules should also not apply to on-exchange derivatives that can be settled by physical delivery. It is the very nature of derivatives markets that participants may take sold positions without owning the underlying subject matter. Controls on sold positions are best dealt with by financial exchange or clearing house business rules imposing open position limits.

8.73 Submissions generally supported the short selling rules not applying to any on-exchange derivatives, whether settled by cash or physical delivery.[783] However, the ASX argued that the short selling restrictions should apply to the secondary trading of warrants.[784] The Advisory Committee agrees, given that there is a limited number of warrants on issue at any one time, and therefore, unlike other derivatives, a limited number of tradeable contracts.

OTC

8.74 There should be no short selling rules for the OTC derivatives market.

Short selling

Recommendation 47. The short selling rules should not apply to any on-exchange or OTC derivatives other than exchange-traded warrants over securities.

781 ss 846, 847. See also ASX Business Rule Guidance Note 6/95 "Business Rules 2.18 and 2.4(4)(i) Short Sales and Option Arbitraging" (19 December 1995).

782 For instance, the short selling provisions do not apply to share ratio contracts: Corp Reg 1.2.06(b). See also ASX r 9.5.47.

783 SFE *On-exchange Submission*, RBA *On-exchange Submission*, BT *On-exchange Submission*.

784 ASX *On-exchange Submission*.

Regulatory information-gathering and enforcement

On-exchange and OTC

ASC investigations and enforcement

8.75 The ASC has a comprehensive range of investigative and surveillance powers and criminal, civil and administrative enforcement powers in relation to all aspects of on-exchange futures trading.[785] The Commission also requires that the holder of an exempt futures markets declaration provide the Commission with any assistance it requires to perform its functions and duties, including providing access to premises and facilities where that market is conducted.[786]

8.76 The ASC's investigative and enforcement powers should apply to all on-exchange and OTC derivatives markets and transactions. These powers should extend to all market participants (including exempt OTC market-makers) and any other persons who can provide any relevant information. In addition, the Commission should have the power to accept legally enforceable undertakings related to derivatives markets, transactions or trading. This power is available to other commercial regulators, such as the Australian Competition and Consumer Commission.[787] The Advisory Committee in one of its previous Reports also recommended that the ASC be given this power.[788] The Financial System Inquiry adopted a similar recommendation.[789]

Informants

8.77 The Advisory Committee recommended in one of its previous Reports that persons should have qualified privilege if they volunteer information to the ASC.[790] A subsequent Senate Committee Report supported this recommendation.[791] Persons who disclose information to the ASC or a financial exchange should be entitled to immunity from liability under any Australian privacy, confidentiality and defamation laws. This statutory protection should be in addition to any financial exchange

785 The ASC investigative powers, including obtaining documents and questioning persons under compulsion, are found principally in the ASC Law Part 3. The ASC also has a range of enforcement powers under the Corporations Law including, for instance, under ss 1138, 1268, 1323, 1324.

786 ASC Policy Statement 70 para 64(c).

787 Trade Practices Act s 87(b).

788 ALRC/CASAC Report, *Collective Investments: Other People's Money* (1993) vol 1 at para 14.24. In the derivatives context, a precedent might be the written agreement entered into between the US Federal Reserve Board and Bankers Trust, in December 1994, after a customer of Bankers Trust experienced substantial losses on complex leveraged swaps. The agreement required the bank to provide increased information to customers entering into specified highly leveraged swaps, including daily valuation of these contracts.

789 *Financial System Inquiry Final Report* Recommendation 27.

790 ALRC/CASAC Report *Collective Investments: Other People's Money* (1993) vol 1 para 14.15.

791 *Report by the Senate Legal and Constitutional Committee on the Investigatory Powers of the Australian Securities Commission* (1995) Recommendation 1.

business rules regulating the provision of information by brokers to an exchange.[792] The Financial System Inquiry also recommended that all persons who provide investigative assistance be protected from liability.[793]

Supervisory disclosure

8.78 Currently, no regulatory authority in Australia systematically collects comprehensive information on activity in OTC derivatives markets. Some data are published annually, though this information refers to the aggregate face value of transactions (the sum of notional principal amounts). This is not an accurate measure of financial exposure.[794]

8.79 There have been a number of international initiatives to improve information-gathering in each jurisdiction.

8.80 *US Derivatives Policy Group (March 1995).* The US Derivatives Policy Group recommended quantitative enhanced reporting by participating firms to regulators, covering counterparty credit risk exposures arising from OTC derivatives activities and related information.[795] The two principal categories of information identified for disclosure were:

- credit concentration[796]
- portfolio credit quality.[797]

8.81 *Basle/IOSCO (May 1995).* The Basle Committee and IOSCO proposed that derivatives regulators in each country introduce a standard supervisory disclosure framework to improve reporting coverage and make national reporting requirements as consistent as possible in order to reduce the need for multiple reporting systems.[798] This would require banks and securities firms to disclose to regulators information on their derivatives activity, including:

- overall market activity

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792 For instance, ASX r 3.15 regulates the disclosure of information by dealers and its use by the ASX Surveillance Department. This rule is designed to provide dealers with a defence to any action by a client for breach of confidentiality in disclosing this information.

793 *Financial System Inquiry Final Report* Recommendation 27.

794 For instance, the real exposure in, say, a "fixed for floating" interest rate swap is not the notional principal of the transaction, but the difference between the fixed rate and the floating rate at particular times.

795 *Framework for Voluntary Oversight* (March 1995).

796 The Derivatives Policy Group said that credit concentration should be determined in light of the top 20 net exposures on a counterparty by counterparty basis.

797 Defined by the Derivatives Policy Group as credit quality aggregates, by counterparty, gross and net replacement value and net exposures (taking into account any collateral and legally enforceable netting arrangements) organised by credit rating category, by industry and by geographic location.

798 Basle/IOSCO, *Framework for Supervisory Information About the Derivatives Activities of Banks and Securities Firms* (May 1995). This Report has been followed up by joint Basle/IOSCO surveys in November 1995 and November 1996 on disclosures about the trading and derivatives activities of banks and securities firms.

- credit risk, divided into:
  - current and potential credit exposure[799]
  - credit enhancement[800]
  - concentration of credit risk
  - counterparty credit quality
- liquidity risk, divided into:
  - market liquidity risk
  - funding risk.

8.82 The Basle/IOSCO document also foreshadowed proposals for disclosure of market risk. These proposals are designed to facilitate the development of internationally consistent conceptual methods for assessing risk exposures related to derivatives.

8.83 *Futures Industry Association Task Force (June 1995).* This Task Force has also proposed that regulatory authorities should have appropriate access, through exchanges and clearing houses, to information about the size and beneficial ownership of client positions.[801]

8.84 *Advisory Committee response.* The Advisory Committee considers that the ASC should have a specific power to obtain information on any aspect of on-exchange or OTC derivatives activity. The Commission should have access to information from any source, including from intermediaries and end-users. This type of supervisory disclosure would assist the ASC in gathering internationally comparable aggregate data on Australian derivatives markets. To avoid duplicate disclosure obligations, the ASC, the RBA, AFIC and the ISC could consult through the Council of Financial Supervisors.[802] In addition, the ASC should have an unrestricted right to release this information at any time to other domestic or foreign regulators, exchanges or clearing houses. Some amendment to the ASC Law[803] may be necessary to overcome possible existing procedural restrictions or delays.[804]

8.85 Some submissions argued that the ASC already has adequate powers to seek this information where appropriate. However, there are currently pre-conditions to the

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799 The Basle/IOSCO proposals define current credit exposure as the cost of replacing the cash flow of contracts with positive mark-to-market value (replacement cost) if the counterparty defaults. They define potential credit exposure as the exposure of the contract that may be realised over its remaining life due to movements in the rates or prices underlying the contract.

800 The Basle/IOSCO proposals describe credit enhancement as the collateral paid to reduce current and potential credit risk exposure.

801 *Futures Industry Association Financial Integrity Recommendations* (June 1995) Recommendation 18.

802 Some submissions, for instance, ABA *OTC Submission*, Phillips Fox *OTC Submission*, RBA *OTC Submission* and John O'Sullivan *OTC Submission*, pointed to the need to avoid duplicate disclosure requirements, for instance, for banks regulated by the RBA.

803 ASC Law s 127.

804 *Johns v ASC* (1993) 11 ACSR 467. This decision may require the ASC to provide a relevant person with a reasonable opportunity to object to the ASC's proposed release of any information to a third party.

Commission exercising its information-gathering powers.[805] Additional and separate information-gathering powers would be appropriate. The ASC could also obtain and analyse information prepared by industry participants.[806] The Advisory Committee notes the recommendation in the Parliamentary Joint Committee Report on derivatives that the ASC include in its Annual Report a synopsis of the types and volumes of derivatives being traded in Australia and any recent regulatory developments. The Government has supported this requirement in principle.[807]

8.86 The ASC's powers should not be limited to information "based on international supervisory disclosure standards", as suggested in the OTC DP. The ASC should be able to act even if the Australian derivatives market develops characteristics that are peculiar to it.

Global regulatory and information-sharing programmes

8.87 The Advisory Committee recognises the benefits of the increasing links between financial exchanges in different jurisdictions. This globalisation process has made effective information-gathering, for the purposes of regulatory surveillance, increasingly important. For instance, a novation clearing house requires timely and comprehensive information on the aggregate financial position of each clearing member for the purpose of enforcing capital requirements and open position limits. This information should cover a member's whole portfolio, taking into account that member's related positions on different exchanges and in the OTC derivative and cash markets. More generally, the globalisation of financial markets increases the sensitivity of each national market to a crisis, wherever it originates, thereby increasing the need for prompt exchange of information and immediate co-ordinated action by regulators in different jurisdictions. Information-sharing is also necessary to counter the possibility of manipulating a market in one jurisdiction by transacting on markets in other jurisdictions.

8.88 There have been several international initiatives to improve information-sharing arrangements between regulators, and strengthen their ability to react effectively in a co-ordinated manner.

8.89 The Windsor Declaration (May 1995) was an agreement between regulators, including the ASC, to improve existing mechanisms for international co-operation and exchange of information among market authorities and regulators and strengthen the

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805 For instance, ASC Law s 44 permits the Commission to require a futures broker to disclose information in relation to particular dealings. However, the Commission may only exercise that power in the circumstances set out in ASC Law s 40. Similarly, there are restrictions on the ability of the ASC to obtain information on futures contracts under ASC Law s 46. The ASC must also comply with the requirements of ASC Law ss 47 and 48. These limitations would restrict the ability of the ASC to use this power to obtain general information concerning levels of on-exchange derivative activity. Likewise, the ASC can use its powers under ASC Law s 32 to inspect documents related to futures transactions, but only in the circumstances set out in ASC Law s 28.

806 *AFMA Manual* Section 6 Chapter 2: Disclosure.

807 Government Response to the Report by the Parliamentary Joint Committee on Corporations and Securities (1996).

arrangements for the supervision of the international futures market, including OTC derivatives. IOSCO and the Basle Committee formally supported this Declaration.

8.90 The US Futures Industry Association has proposed that each exchange/clearing house should have procedures and systems for sharing information regarding the trading activities of market participants.[808] This information may assist regulators to monitor international cross-market exposures.

8.91 A Report by the Technical Committee of IOSCO (1996) dealt with the purpose and structure of international information-sharing agreements. It surveyed the extent to which information on large exposures which could place a clearing house at risk if a member defaulted is currently available to market regulators including clearing houses.[809]

8.92 In March 1996, a large number of exchanges, including Australian exchanges, signed an "International Information Sharing Agreement and Memorandum of Understanding". To facilitate and augment the exchange agreement, regulators from various jurisdictions, including Australia, signed a "Declaration on Co-Operation and Supervision of International Futures Exchanges and Clearing Organisations".[810]

8.93 The Advisory Committee supports these initiatives for international regulatory co-operation and the voluntary sharing of derivatives trading information between government regulators and market self-regulatory bodies, such as exchanges and clearing houses. The Financial System Inquiry also supports these global programmes.[811]

8.94 The Advisory Committee proposes that financial exchanges and clearing houses should be protected from legal liability when sharing information with domestic or foreign regulators and self-regulatory bodies. Respondents generally agreed.[812] The Financial System Inquiry made a similar recommendation.[813]

Regulatory information-gathering and enforcement

ASC

808 *Futures Industry Association Financial Integrity Recommendations* (June 1995) Recommendations 11 and 13.

809 IOSCO Technical Committee *Report on Co-Operation Between Market Authorities* (March 1996).

810 See, for instance, *ASC Media Release* 96/42, "ASC and SFE sign international agreements to share information".

811 *Financial System Inquiry Final Report* Recommendation 29.

812 SFE *On-exchange Submission*, ASX *On-exchange Submission*, RBA *On-exchange Submission*, BT *On-exchange Submission*. This protection would accord with *Futures Industry Association Financial Integrity Recommendations* (June 1995) Recommendation 12. Currently, the SFE has qualified privilege only for disciplinary proceedings: s 1141A. The ASX has somewhat wider, but still not comprehensive, qualified privilege: s 779.

813 *Financial System Inquiry Final Report* Recommendation 57.

Recommendation 48. The ASC should have comprehensive investigative and enforcement powers concerning any aspect of on-exchange and OTC derivatives markets or transactions. The ASC should also be able to accept legally enforceable undertakings from derivatives market participants.

Persons who disclose information to the ASC or a financial exchange should be entitled to immunity from liability under any Australian privacy, confidentiality and defamation laws.

The ASC should have comprehensive powers to:

- require derivatives market participants to disclose information about their derivatives activities
- obtain from financial exchanges and clearing houses information about the size and beneficial ownership of client positions
- release this information at any time to foreign regulators, exchanges or clearing houses.

Financial exchanges and clearing houses

Recommendation 49. Australian financial exchanges or clearing houses who, in good faith, share information with Australian or overseas regulators, exchanges or clearing houses, should have statutory immunity from liability under any relevant Australian privacy, confidentiality and defamation laws.

Ultra vires

8.95 Some entities may be prohibited from, or restricted in, dealing in derivatives transactions. The validity or enforceability of any derivatives transactions into which they enter could be jeopardised by their lack of power to act as contracting parties (the doctrine of ultra vires).

Trusts

8.96 The proposals for the introduction of netting legislation, outlined in the CASAC Netting Sub-Committee's Final Report,[814] do not deal with the capacity of a party to enter into derivatives, and related netting, contracts. Some of Australia's most significant financial entities are trusts. There are several problems concerning the capacity of some trustees to enter into these transactions:

- the trustee may lack authority to enter into all or some derivatives transactions under the instrument setting up the trust. This problem can be exacerbated where (as is very common) the contracting party is trustee of more than one trust

814 CASAC Netting Sub-Committee Final Report *Netting in Financial Markets Transactions* (June 1997).

- entering into a particular derivatives transaction may be taken to be an improper exercise of the trustee's discretion

- a creditor's right of subrogation to a trustee counterparty's right of indemnification out of a trust fund may be defeated by any breach of trust by the trustee (whether or not related to the power of the trustee to enter into the derivatives contract).[815]

8.97 Theoretically, this ultra vires problem can apply to any financial market instrument. However, in practice, it is more likely for trust deeds to place restrictions on derivatives, rather than securities, transactions.

8.98 The ultra vires risk is borne by counterparties in the OTC derivatives market. In exchange derivatives markets with novation clearing, this risk is borne by the contracting brokers who act as principals in allotment transactions on that market.

8.99 On one view, the ultra vires doctrine has the potential to seriously and unfairly harm participants in the OTC derivatives market, particularly if large transactions are successfully challenged on this ground. The opposite view is that trust beneficiaries should be able to rely on restrictions in trust deeds to protect them against any unauthorised activities by their trustees. There is also the problem that trustees may be personally liable to the full extent of transactions for even minor breaches of the trust instrument, such as entering into transactions only marginally in excess of their authorised limit.

8.100 There are several policy options for dealing with the conflicting interests of OTC derivatives market participants or trust beneficiaries.

8.101 *Policy Option 1.* This would provide that the validity of any OTC derivatives transaction and its enforceability against trust assets cannot be challenged on the basis of lack of capacity, whether or not the counterparty has notice of the trustee's lack of power. The beneficiary's interest could be partly protected by statutory offences for trustees who enter into derivatives transactions without power. The argument against this policy is that it may override the public policy of preventing certain trusts that serve the public interest from jeopardising their financial stability by dealing in derivatives.

8.102 *Policy Option 2.* This would provide that, unless a trust deed provides expressly to the contrary:

- the trustee is presumed to have authority to enter into any OTC derivatives transaction
- the exercise of that authority is taken to constitute a proper exercise of power by the trustee [unless the counterparty has actual knowledge to the contrary]

815 These problems are further discussed in the Australian Investment Managers' Association and AFMA Paper *Dealing Undisclosed in OTC Markets: Issues for Investment Managers and Banks* (September 1996).

- the trustee has an unqualified right of indemnification out of the trust fund in respect of any transaction falling within the presumption. This right of indemnity should subsist and be capable of enforcement notwithstanding any other act or omission by the trustee amounting to a breach of trust.

8.103 *Policy Option 3.* This would provide that the counterparty to any OTC derivatives transaction is not affected by an express provision depriving the trustee of authority, unless the counterparty had actual notice of the existence of the provision at the time of contracting and the counterparty is exonerated from any duty of inquiry. The problem with this policy option is the difficulty of determining whether a person has actual knowledge of a restriction on power.

8.104 *Policy Option 4.* This would provide that any entity that has a prohibition, or restriction, on its capacity to enter into derivatives should identify itself in a public register. There would be an irrebuttable presumption in law that any entity not on that register has full power to enter into OTC derivatives contracts. Likewise, there would be an irrebuttable presumption in law that any identified restriction on power was the only restriction.

8.105 *Policy Option 5.* This would leave it to the contracting parties to deal with this matter through their own arrangements.

8.106 *Related issue.* A related issue is whether there should be any presumptions where a trustee is acting as trustee of more than one trust and, if so, what they should be. For instance, it could be provided that a counterparty:

- is entitled to presume that a trustee of a trust that authorises the making of the relevant derivatives transaction is contracting as trustee of that trust and not wholly or partly in any other capacity
- is not obliged to check on the application of money paid under the contract

unless the trustee expressly stipulates that it is contracting wholly or partly in another capacity. Where a transaction is entered into pursuant to a master agreement, it might be sufficient if any of these presumptions is satisfied at the time of entry into the master agreement.

Life insurance companies

8.107 The ultra vires problem may also apply to life insurance companies. Currently, an OTC derivatives counterparty to an insurance company should obtain evidence that the derivatives transaction is for the purposes of the business of the insurance company's statutory fund. This is necessary to ensure that the fund is available to meet the life company's liabilities under that transaction.

Other entities

8.108 The ultra vires doctrine may affect other entities such as friendly societies, building societies and government entities.

Advisory Committee position

8.109 The Advisory Committee anticipates that there will continue to be considerable debate in the commercial community on how to resolve these matters.

8.110 The Advisory Committee considers that all entities to be prudentially regulated by the proposed Australian Prudential Regulation Commission[816] should not be able to rely on the doctrine of ultra vires.

8.111 In other circumstances, there is considerable merit in adopting policy option 4 (the public register). However, this policy option may not resolve the difficulty of what, if any, inquiries a potential counterparty would have to make where an entity states in the public register that it has a restriction (rather than a prohibition) on its capacity to enter into derivatives.

8.112 There also remains the issue of the circumstances, if any, in which a trustee should be relieved from full personal responsibility for acting beyond authority or improperly exercising a discretion. The Advisory Committee also notes that any amendments to Australian law on ultra vires would not resolve the problem of dealing with entities in jurisdictions where the ultra vires doctrine has not been excluded.

8.113 In summary, the Advisory Committee considers that the ultra vires issue creates considerable policy problems that are not confined to derivatives and need to be considered in a broader context. The Advisory Committee has not reached a settled position in this Report. The issues surrounding ultra vires could form the subject of a further Advisory Committee review and Report. The Netting Sub-Committee also supported this further review.[817]

Gaming and wagering legislation

8.114 The primary purpose of gaming and wagering legislation is to regulate various forms of gambling and betting. However, this legislation could also affect the validity of some derivatives transactions.

On-exchange

8.115 Currently, all transactions on futures exchanges and option contracts on securities exchanges are exempt from gaming and wagering legislation.[818] The On-exchange Draft Report recommended that this exemption should apply to all on-exchange derivatives transactions. Respondents agreed.[819]

OTC

816 *Financial System Inquiry Final Report* Recommendations 30 and 31.

817 CASAC Netting Sub-Committee Final Report *Netting in Financial Markets Transactions* (June 1997).

818 ss 1141, 778.

819 SFE *On-exchange Submission*, ASX *On-exchange Submission*, RBA *On-exchange Submission*, BT *On-exchange Submission*, AIMA *On-exchange Submission*.

8.116 Doubts have been expressed from time to time as to whether financial contracts such as currency and interest rate swaps may be invalidated by State gaming and betting laws.[820] Although the prevailing legal opinion in Australia is that these laws do not invalidate swap agreements, it is clearly desirable that the issue be put beyond doubt.

8.117 The Advisory Committee considers that all transactions on Australian OTC derivatives markets should be specifically excluded from the gaming and wagering legislation. Submissions strongly supported this approach.[821] The Advisory Committee will leave it to the Government to determine the best constitutional arrangements to achieve this result. However, if the Government's legislative response to the recommendations in this Final Report will be later than the enactment of the netting legislation proposed by the Netting Sub-Committee,[822] this clarifying provision in relation to gaming and wagering should be introduced with the proposed netting legislation.

Gaming and wagering legislation

Recommendation 50. All on-exchange and OTC derivatives transactions should be expressly excluded from gaming and wagering legislation. However, if the Government's legislative response to the recommendations in this Final Report will be later than the enactment of the netting legislation proposed by the Netting Sub-Committee, this clarifying provision in relation to gaming and wagering should be introduced with the proposed netting legislation.

Takeovers

8.118 This Report does not deal with the possible application of Chapter 6 of the Corporations Law to various types of equity derivatives.[823] The Advisory Committee understands that this matter is being considered by Treasury in its review of the takeover provisions, pursuant to the *Corporate Law Economic Reform Program*.

Netting

8.119 The CASAC Netting Sub-Committee proposes the enactment of facilitative legislation, as a matter of priority, to clarify the law of netting over a range of

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820 In *Westdeutsche Landesbank Girozentrale v Islington London Borough Council* [1996] 2 All ER 961, there were comments to the effect that interest rate swaps would have constituted wagers for the purpose of gaming and wagering legislation except for their specific exclusion from that legislation by the UK Financial Services Act 1986.

821 ABA *OTC Submission*, IBSA *OTC Submission*, ISDA *OTC Submission*, JP Morgan *OTC Submission*, Phillips Fox *OTC Submission*, RBA *OTC Submission*, Westpac *OTC Submission*, Treasury (formerly Attorney-General's Department) *OTC Submission*, AFMA *OTC Submission*, ASC *OTC Submission*, John O'Sullivan *OTC Submission*.

822 CASAC Netting Sub-Committee Final Report *Netting in Financial Markets Transactions* (June 1997).

823 These matters are discussed in S Ansell, "The Application of Equity Derivatives in Mergers and Acquisitions" (1997) 15 *Company and Securities Law Journal* 218.

financial contracts, including on-exchange and OTC derivatives transactions. This draft legislation is set out in the CASAC Netting Sub-Committee Final Report *Netting in Financial Markets Transactions* (June 1997). That Report is separately published under the auspices of the Advisory Committee, in conjunction with this Final Report.

8.120 The Advisory Committee supports the expedited enactment of facilitative netting legislation. It notes that the Financial System Inquiry also supported the introduction of legislation to give legal certainty to the netting of financial transactions.[824]

824 *Financial System Inquiry Final Report* Recommendation 59.

Appendix 1

List of Recommendations

Distinction between wholesale and retail participants

Recommendation 1. The legislation should distinguish between wholesale and retail participants in derivatives markets. The following persons should be classified as wholesale participants in derivatives markets:

- all persons classified as wholesale in ASC Policy Statement 121
- all listed companies
- related companies of listed companies that "opt up" to being wholesale end-users by resolution of the board of directors
- large proprietary companies.

Brokers or advisers who do not satisfy any other wholesale participant test should be permitted to "opt down" from wholesale to retail.

Retail participation in OTC derivatives markets

Recommendation 2. There should be no regulatory restrictions on retail participation in OTC derivatives markets, provided the safeguards for retail end-users recommended in this Report are implemented.

Core financial market provisions

Recommendation 3. The Corporations Law should have core provisions for the regulation of financial markets and financial market instruments, with supplementary provisions that, for certain limited purposes, distinguish between:

- derivatives and securities, and
- on-exchange and OTC markets.

Definition of derivatives

Recommendation 4. A derivative should be defined in the Corporations Law as any agreement:

- the value of which is ultimately derived from, or varies according to, the value of one or more assets, rates, indices or other underlying (*derived value element*), and
- whereby one or both parties, at some future time, may have to provide cash or other consideration (excluding any initial or periodic consideration that is fixed at the time the agreement is entered into) to the counterparty or a substitute counterparty (such as the clearing house), that consideration

ultimately being determined in whole or part by reference to the derived value element (*liability element*).

Only the following options should be classified as derivatives:

- options over derivatives
- options over securities (other than options issued by a company permitting the taker to subscribe for the company's unissued shares, which should be classified as securities)
- exchange-traded options
- any other category of option prescribed by regulation (this could cover commodity options that are being used as risk management tools or otherwise in a similar way to other derivatives).

The Corporations Regulations could set out specific classes of agreements that are not to be regarded as derivatives, for instance:

- agreements under which physical delivery of a commodity other than a currency is mandatory
- agreements where the consideration can be varied only by reference to an inflation index (such as the Consumer Price Index)
- at-call or term deposits with banks or other financial institutions
- all insurance contracts regulated by the ISC
- chattel and real property mortgages.

In addition, there should be a power to declare any other class of agreements not to be derivatives.

Definition of securities

Recommendation 5. A security, in the context of financial markets regulation, should be defined as:

- a share in, or debenture of, a body corporate
- a debenture, stock or bond issued or proposed to be issued by a government entity
- a prescribed interest (collective investment scheme interest)
- a unit of a share or prescribed interest
- an option issued by a company permitting the taker to subscribe for the company's unissued shares.

Interaction of the derivatives and securities definitions

Recommendation 6. All securities should be excluded from the definition of derivatives. However, if, in the future, products are artificially structured as securities to avoid disclosure requirements, the Government should consider regulating products that could be either derivatives or securities as both, subject to the ASC exempting the products from one or other form of regulation.

Regulation of derivatives markets

Definition of derivatives market

Recommendation 7. A person should be prohibited from conducting a derivatives market unless authorised.

A "derivatives market" should be defined as:

> "any market, exchange or other place at which, or a facility by means of which, in Australia:
>
> - derivatives contracts are regularly acquired or disposed of
> - offers to enter into derivatives contracts are regularly made or accepted, or
> - information is regularly provided about the prices at which, or the consideration for which, particular persons, or particular classes of persons, propose, or may reasonably be expected, to acquire or dispose of derivatives contracts, whether or not transactions are made on or through that facility
>
> and where the ASC, in the public interest, designates the activity as a derivatives market".

In considering whether to designate an activity as a derivatives market, the ASC should take into account whether the activity might be more appropriately dealt with under the licensing provisions. No person should be subject to both derivatives market regulation and derivatives licensing for the same activity.

Authorising derivatives markets

Recommendation 8. Any applicant for authorisation of a market that involves fungible derivatives transactions (that is, any standardised agreements that are fully interchangeable with substitute transactions of the same class) and from which retail end-users are not excluded should only be authorised to conduct a financial exchange. There should be a prohibition on persons holding out or implying that they conduct a financial exchange unless they have been so approved.

Any applicant for authorisation as an OTC derivatives market should be required to show that the market will be conducted in a fair and orderly manner. Any authorisation could be made subject to minimum standard conditions.

The ASC should have appropriate powers to ensure the fair and orderly conduct of OTC derivatives markets.

A derivatives transaction should not be void merely because it is entered into on an unauthorised derivatives market.

Authorising financial exchanges

SFE and ASX

Recommendation 9. The SFE and ASX should be automatically authorised as financial exchanges for all classes of products for which they provide a market before enactment of the relevant amending legislation.

The SFE and ASX, as financial exchanges, should be entitled to conduct a market in any other class of derivatives whose business rules have been approved and for which they have satisfactory contract protection arrangements. These exchanges should also be required to obtain separate approval if they seek to pool the contract protection resource backing for any combined derivatives and securities markets.

Other financial exchanges

Recommendation 10. Any other body corporate should be permitted to seek authorisation as a financial exchange that conducts a market in derivatives.

An application for authorisation to conduct an intermediated financial exchange should demonstrate:

- the suitability of the applicant
- appropriate business rules
- adequate contract protection for transactions taking place on the exchange
- satisfactory arrangements to prevent trading defaults by exchange members
- adequate compensation arrangements
- that the public interest will be served by granting the application.

An application for authorisation to conduct a disintermediated financial exchange should demonstrate:

- the suitability of the applicant
- appropriate business rules
- adequate contract protection for transactions taking place on the exchange
- that the public interest will be served by granting the application.

An intermediated or disintermediated financial exchange should be permitted to conduct a market in any class of derivatives if it has satisfactory business rules for those derivatives covering, for instance, product specifications, any particular qualifications and experience required for intermediaries to deal in those derivatives and any additional settlement requirements for these classes.

An intermediated or disintermediated financial exchange should only be able to establish a market in derivatives or introduce new classes of derivatives if it can demonstrate that:

- its contract protection arrangements will be adequate to accommodate the additional derivatives

- its compensation arrangements will remain adequate after the new derivatives have been introduced.

All financial exchanges

Recommendation 11. There should be a power to disallow amendments to the business rules of any financial exchange, clearing house or other organisation providing contract protection for trading in financial instruments, and any other relevant self-regulatory body.

Contract protection

Recommendation 12.

On-exchange

An applicant for approval as a financial exchange should have to establish that the exchange will have satisfactory contract protection arrangements for controlling counterparty credit risk.

Where these contract protection arrangements involve novation clearing, there should be satisfactory risk controls, resource backing and stress testing arrangements.

OTC

There should be no general obligation to offer contract protection mechanisms in any OTC derivatives market, though some settlement arrangement may be necessary to permit the market to be conducted in an orderly manner.

The reliability of any contract protection mechanism proposed by an applicant to conduct an OTC derivatives market should be evaluated as part of the market application. The ASC should also have appropriate powers to supervise the operation of any contract protection mechanism employed on that market.

Any clearing house that covers OTC as well as on-exchange derivatives trading should be required to fully separate its on-exchange and any OTC resource backing.

On-exchange and OTC derivatives market licensing

Single licensing system

Recommendation 13. There should be a single financial markets licensing system.

On-exchange broking

Recommendation 14. Persons should be prohibited from carrying on a business, or holding out that they carry on a business, of dealing in any on-exchange derivatives contract on behalf of another person unless they hold a financial markets licence endorsed for on-exchange derivatives broking.

On-exchange own account dealings

Recommendation 15. The ASC should have a power to ban persons who behave improperly from dealing on a financial exchange as principals on their own account.

On-exchange advising

Recommendation 16. Persons should be prohibited from advising on on-exchange derivatives, or holding out that they carry on a derivatives advice business unless they hold a financial markets licence endorsed for advising in derivatives.

Recommendation 17. Media advisers who are permitted to operate without a licence should be required to include in their publications appropriate warnings about the limitations of their general advice.

Recommendation 18. Solicitors and accountants in public practice who give merely incidental derivatives advice need not be licensed provided:

- the advice forms an integral and merely incidental part of their overall services
- they charge no discrete fee for the advice
- they do not receive any commissions or other benefits from product issuers, and
- they belong to a recognised professional body that has appropriate standards of competence and conduct.

Transitional

Recommendation 19. Existing futures and securities licensees should be permitted to continue to deal or advise in those on-exchange derivatives products for which they are authorised at the time of enactment of the amending legislation. They should not be required to obtain a new financial markets licence.

OTC broking

Recommendation 20. Persons should be prohibited from carrying on a business, or holding out that they carry on a business, in Australia, of:

- dealing in any OTC derivatives contract on behalf of another person, or
- arranging for one person to enter into an OTC derivatives contracts with another person

unless they have a financial markets licence endorsed for acting as a broker in the OTC derivatives market.

OTC market-makers to wholesale end-users

Recommendation 21. Persons should be prohibited from carrying on a business, or holding out that they carry on a business, in Australia, of structuring and entering, as principal, into either, or one, side of an OTC derivatives transaction with an arm's length wholesale counterparty unless they have a financial markets licence endorsed for so acting.

In determining whether to grant a financial markets licence endorsed for market-making in the wholesale derivatives market, the ASC should apply the following prudential criteria:

- risk management systems
- capital standards.

The following two classes of market-makers (exempt OTC market-makers) should be exempt from the licensing requirements:

- entities regulated by the RBA, and
- any other market-maker (or class of market-maker) whose risk management system and capital standards are, to the satisfaction of the ASC, appropriately supervised by another domestic or foreign regulator or SRO.

OTC market-makers to retail end-users

Recommendation 22. Persons should be prohibited from carrying on a business, or holding out that they carry on a business, in Australia, of structuring and entering, as principal, into either, or one, side of an OTC derivatives transaction with an arm's length retail counterparty, unless they have a financial markets licence endorsed for so acting.

In determining whether to grant a financial markets licence endorsed for market-making in the retail derivatives market, the ASC should apply competence and integrity as well as prudential criteria. Exempt OTC market-makers should not have to satisfy the ASC that they meet the prudential requirements.

ASC power to exempt OTC end-users from market-makers licensing

Recommendation 23. The ASC should have a power to exempt parties whose activities might sometimes constitute market-making, but who are predominantly end-users, from the OTC market-maker licensing provisions.

OTC advising

Recommendation 24. Persons should be prohibited from carrying on a business, or holding out that they carry on a business, of advising on OTC derivatives transactions, unless they hold a financial markets licence endorsed for OTC derivatives advising.

The principles relating to media advice and incidental advice by on-exchange advisers should also apply to OTC advisers.

On-exchange and OTC exemptions

Recommendation 25. There should be appropriate exemptions from the licensing provisions, including for fund managers, treasury operations and trustee corporations.

Prudential regulation: risk management

Recommendation 26. OTC market-makers (other than RBA-regulated entities and other exempt OTC market-makers) should be required to satisfy the ASC that they have a minimum satisfactory risk management system for their derivatives transactions.

The ASC should have the power to conduct surveillance to verify that the risk management systems exist and operate in the way described by these market-makers.

The ASC should have the power to suspend, or if necessary revoke, the licence of any of these market-makers if it considers that the licensee no longer has a satisfactory risk management system.

These market-makers should be required to confirm in each annual report that they have an effective risk management system for the types of derivatives they transact.

Prudential regulation: capital requirements

Recommendation 27. OTC market-makers (other than RBA-regulated entities and other exempt OTC market-makers) should be required to satisfy the ASC that they meet minimum capital standards applying to all their OTC derivatives trading activities.

The ASC should have the power to conduct surveillance to verify that these market-makers continue to meet minimum capital standards.

The ASC should have the power to suspend, or if necessary revoke, the licence of any of these market-makers if it considers that the licensee no longer meets minimum capital standards.

Client agreements

Recommendation 28. There should be a statutory requirement for on-exchange advisers and OTC brokers, market-makers and advisers to enter into client agreements with their retail clients at the outset of their legal relationship. These forms should have minimum standard provisions, to be settled in consultation with industry bodies.

Risk disclosure

Recommendation 29.

On-exchange risk disclosure

On-exchange brokers and advisers should give retail clients, and those wholesale clients who do not waive their right (eligible wholesale clients), generic risk disclosure statements at the outset of their professional relationship.

On-exchange brokers should give retail clients and eligible wholesale clients specific risk disclosure statements before first transacting for them in the relevant classes of derivatives.

On-exchange advisers should give retail clients and eligible wholesale clients specific risk disclosure statements at the time of first advising them about the relevant classes of derivatives.

An on-exchange broker or adviser should be required to receive from a retail client written acknowledgement that the client has received, read and understood the risk disclosure statement before dealing in or recommending an on-exchange derivatives product for that client.

OTC risk disclosure

OTC brokers and advisers should give a generic risk disclosure statement to retail clients and eligible wholesale clients at the outset of the professional relationship. Likewise, OTC market-makers (including exempt OTC market-makers) should provide that generic risk disclosure statement to retail end-users and eligible wholesale end-users, before first accepting them as counterparties.

An OTC intermediary should be required to receive from a retail end-user written acknowledgement that the end-user has received, read and understood the generic risk disclosure statement. That acknowledgement must be received before first transacting with, or on behalf of, or recommending an OTC derivatives product to, that retail end-user.

Any person who provides personal advice about a particular OTC derivatives transaction should be obliged to disclose to the client (whether wholesale or retail) any specific material risks associated with that transaction.

Waiver

Corporate wholesale clients may waive their rights to receive all or any on-exchange or OTC risk disclosure statements only by resolution of their board of directors.

Liability

It should be an offence to fail to provide an on-exchange or OTC risk disclosure statement. Persons who fail to provide a mandatory risk disclosure statement should also be civilly liable in damages for any loss that is attributable to that failure. However, no transaction should be void or voidable due to failure to give risk disclosure.

General derivatives advice

Recommendation 30. A licensee providing general derivatives advice should warn recipients that:

- the general advice has not taken into account the particular investment objectives, financial situation and needs of the recipient, and
- the recipient should assess that advice in that context.

Personal derivatives recommendations

Recommendation 31. On-exchange and OTC derivatives advisers who make personal derivatives recommendations to retail clients should be required, regardless of any purported limitation in a particular agreement or other related statement, to:

- have regard to the information advisers have about their clients' investment objectives, financial situation and particular needs
- make reasonable inquiries from clients where that information is not adequate
- conduct reasonable investigation and product research about the securities recommended, and
- prepare their recommendations in light of these considerations.

Advisers should be required to provide appropriate warnings to retail clients who decline to provide relevant information.

Advisers who breach the "know your client" requirement should be liable to their retail clients civilly in damages for any loss that is attributable to that breach. However, no transaction should be void or voidable due to a breach.

There should be a prohibition on misleading or deceptive conduct in relation to the giving of any derivatives advice.

Acting as counterparty to client

Recommendation 32. On-exchange derivatives brokers should not be permitted to enter into on-exchange derivatives transactions with their clients without first obtaining the consent of those clients.

Benefits disclosure

Recommendation 33. On-exchange and OTC derivatives advisers should be required to disclose to their retail clients particulars of any material benefits, advantages or other interests which may affect their personal derivatives recommendations. There should be a specific exemption for any actual or anticipated transaction profit from a recommended OTC derivatives transaction where an OTC adviser is also the intended counterparty to that transaction.

Contract notes

Recommendation 34.

On-exchange

The contract note requirements for each class of on-exchange derivatives should be determined by the business rules of any financial exchange on which they are traded.

OTC

Brokers who enter into OTC transactions as agents for their clients (whether wholesale or retail) should be obliged within a stipulated period to provide their clients either with a copy of the contract document or a contract note setting out the essential details of the transaction.

Periodic statements

Recommendation 35.

On-exchange

On-exchange derivatives brokers should be required to send monthly statements to their clients where, during the preceding month, they have:

- held money or property on the client's account
- acquired a derivatives contract that has not been disposed of, or
- had the client's authority to operate a discretionary account.

OTC

An OTC broker should be obliged to furnish a monthly statement to a client (whether wholesale or retail) where:

- any money or other property (including any deposits lodged by the client with the broker against continuing liabilities under current or anticipated OTC derivatives contracts) is held for that client during that period

- any money is paid or received by the broker under any completed, closed out or continuing OTC derivatives contract to which the client is a principal during that period, or
- any fee or other charge is imposed by the broker during that period.

Client funds

On-exchange

Recommendation 36. On-exchange derivatives brokers should be required to separate their clients' funds from their own funds.

Recommendation 37. It should be left to the discretion of any financial exchange to determine the method of accounting for derivatives trading. Also, financial exchanges on which both derivatives and securities trading take place should be permitted to determine whether segregated or trust accounts are used on their derivatives and securities markets, respectively. It should not be necessary for the same accounting system to be used for all transactions on a particular exchange.

OTC

Recommendation 38. OTC derivatives brokers should hold the funds of their wholesale and retail clients separately from their own funds in a trust account.

A party to any OTC derivatives transaction who receives any deposit or margining funds from its counterparty should be obliged to hold those funds in trust, unless both parties are wholesale participants and the terms of a particular OTC derivatives transaction or the relevant provisions of a Master Agreement stipulate some other arrangement.

Any trust arrangements should be subject to any statutory priorities.

Client property

Recommendation 39. On-exchange and OTC derivatives brokers should hold the property of their wholesale and retail clients separately from their own assets.

A party to any OTC derivatives transaction who receives any property from its counterparty to secure deposit or margining obligations, or to be held pending settlement, should be obliged to hold that property in trust, unless both parties are wholesale participants and the terms of a particular OTC derivatives transaction or the relevant provisions of a Master Agreement stipulate some other arrangement.

Records of clients' or counterparties' trading

Recommendation 40.

On-exchange

On-exchange derivatives brokers should be required to keep records of the orders received and transactions made on behalf of their wholesale and retail clients for seven years.

OTC

OTC derivatives brokers should be required to keep records of the orders received and transactions made on behalf of their wholesale and retail clients for seven years.

OTC market-makers to retail end-users should be required to keep records of their transactions with these end-users for seven years.

Record of proprietary trading

Recommendation 41. Own account positions of on-exchange derivatives brokers should be clearly identifiable and separately recorded, whether or not in a separate formal register.

Discretionary accounts

Managing the accounts

Recommendation 42. OTC licensees should be prohibited from operating a discretionary account on behalf of an OTC retail end-user without an appropriate written and signed client agreement.

Suitability

Recommendation 43. On-exchange or OTC licensees who operate discretionary accounts should be required to have reasonable grounds for believing that any transactions which they effect or arrange in the exercise of their discretion are suitable for the wholesale or retail client concerned, in view of the facts that are known, or should reasonably be known, about the client's personal and financial situation.

Marking-to-market and buy-backs

Recommendation 44. There should be no statutory marking-to-market obligations in the OTC derivatives market. However, an OTC market-maker dealing with a retail end-user should be obliged (for a reasonable price if required) to indicate to the retail end-user at the outset of the transaction whether or not the market-maker undertakes to buy back the contract, at the request of the retail end-user, prior to its completion.

Controls on marketing

Recommendation 45. The ASC should have a power to control undesirable derivatives advertising by prohibiting a person from publishing or broadcasting statements concerning on-exchange or OTC derivatives contracts or derivatives broking or advising businesses.

There should be controls over:

- misleading or deceptive conduct in relation to on-exchange or OTC derivatives contracts
- false or misleading statements or information that could induce persons to enter into on-exchange or OTC derivatives contracts.

Persons should be prohibited from inducing or attempting to induce, through unsolicited contact, any retail person to enter into any on-exchange or OTC derivatives transaction, unless they hold a financial markets licence, a term of which permits them to cold call retail end-users.

The ASC's controls on marketing should extend to cross-border marketing.

Offences

Recommendation 46. The on-exchange derivatives offence provisions should be based on those in Part 8.7 of the Corporations Law, with the following amendments:

- the insider trading rules should be based on those for securities in Part 7.11 Div 2A (rather than Part 8.7 Div 1) and should relate only to derivatives over securities
- the market manipulation provisions should specifically apply to any:
  - trading on any derivatives market to manipulate an underlying Australian physical market
  - trading on any underlying physical market to manipulate an Australian derivatives market
  - trading on any Australian derivatives market or underlying physical market to manipulate a foreign market
- the current controls over frontrunning should be reformed to ensure that they take into account contemporary broking practice.

There should be similar OTC insider trading and market manipulation offence provisions, modified to take into account accepted OTC practices.

Short selling

Recommendation 47. The short selling rules should not apply to any on-exchange or OTC derivatives other than exchange-traded warrants over securities.

Regulatory information-gathering and enforcement

ASC

Recommendation 48. The ASC should have comprehensive investigative and enforcement powers concerning any aspect of on-exchange and OTC derivatives markets or transactions. The ASC should also be able to accept legally enforceable undertakings from derivatives market participants.

Persons who disclose information to the ASC or a financial exchange should be entitled to immunity from liability under any Australian privacy, confidentiality and defamation laws.

The ASC should have comprehensive powers to:

- require derivatives market participants to disclose information about their derivatives activities
- obtain from financial exchanges and clearing houses information about the size and beneficial ownership of client positions
- release this information at any time to foreign regulators, exchanges or clearing houses.

Financial exchanges and clearing houses

Recommendation 49. Australian financial exchanges or clearing houses who, in good faith, share information with Australian or overseas regulators, exchanges or clearing houses, should have statutory immunity from liability under any relevant Australian privacy, confidentiality and defamation laws.

Gaming and wagering legislation

Recommendation 50. All on-exchange and OTC derivatives transactions should be expressly excluded from gaming and wagering legislation. However, if the Government's legislative response to the recommendations in this Final Report will be later than the enactment of the netting legislation proposed by the Netting Sub-Committee, this clarifying provision in relation to gaming and wagering should be introduced with the proposed netting legislation.

Appendix 2

Respondents to the OTC Discussion Paper

AMP Investments
ANZ Banking Group
Attorney-General's Department (now Treasury)
Australian Accounting Research Foundation
Australian Bankers' Association
Australian Financial Markets Association
Australian Investment Managers' Association
Australian Securities Commission
Australian Society of Corporate Treasurers
Bankers Trust Australia Limited
BZW Australia Limited
Commonwealth Bank
Coopers & Lybrand
Corrs Chambers Westgarth
International Banks and Securities Association of Australia
International Councils of Securities Associations
International Swaps and Derivatives Association
Investment Funds Association of Australia
John O'Sullivan of Freehill Hollingdale & Page
JP Morgan
Mallesons Stephen Jaques
Merrill Lynch Japan Incorporated
National Australia Bank
National Mutual Funds Management
NatWest Markets Australia Limited
Phillips Fox
Reserve Bank of Australia
Securities Industry Association
Securities Institute of Australia
State Bank of NSW
Sydney Futures Exchange
Westpac Banking Corporation

Appendix 3

Respondents to the On-Exchange Draft Report

ANZ Banking Group
Australian Accounting Research Foundation
Australian Bankers' Association
Australian Financial Markets Association
Australian Investment Managers' Association
Australian Securities Commission
Australian Society of Corporate Treasurers
Australian Stock Exchange
Bankers Trust Australia Limited
Cornwall Stodart
CSR Limited
Derivative Fund Management Limited
International Banks and Securities Association of Australia
Merrill Lynch (Australia) Pty Limited
Minter Ellison
Mr M Hains
Mr W Irving & Mr M Ryan
Reserve Bank of Australia
Securities Exchanges Guarantee Corporation Limited
Sydney Futures Exchange
The Partnership Group
The Treasury

Appendix 4

Advisory Panel

Brenda Berkeley, Treasury
Ian Crofts, Australian Society of Corporate Treasurers
John Currie, Henry Davis York
Ken Farrow, Australian Financial Markets Association
Marilyn Forde, Australian Society of Corporate Treasurers
Michael Hains, Attorney
Leigh Hall, AMP Society
David Hornery, ANZ Banking Group
Tony Hunter, Australian Stock Exchange
Grahame Johnson, Reserve Bank of Australia
Paula Kelly, Australian Stock Exchange
Nick Korner, Blake Dawson Waldron
Steven Lambert, Merrill Lynch Pty Limited
Stephen Lyons, Bankers Trust Australia Limited
Geoff Marriott, ANZ Banking Group
Jim Murphy, Treasury
Keven Rainbow, CSR Limited
John Rappell, Australian Financial Markets Association
Malcolm Rodgers, Australian Securities Commission
Malcolm Starr, Sydney Futures Exchange
Ellen Stoddart, Australian Accounting Research Foundation
Geoff Thompson, Reserve Bank of Australia
Peter Warne, Bankers Trust Australia Limited
Robert Webster, International Banks and Securities Association of Australia
Julie Wright, Australian Investment Managers' Association