OTC DERIVATIVES
FILLING THE GAPS IN INVESTOR PROTECTION

by

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SYNOPSIS

The dramatic growth of over-the-counter (OTC) derivatives in the last two decades and the ever-expanding range of financial derivative have triggered concerns as regards investor protection. These concerns have been exacerbated in recent times by phenomenal losses sustained by several large corporations (including municipalities), in the United States, Europe and Asia.

This thesis seeks to evaluate the capacity of the existing regulatory framework in Australia to provide protection to participants trading in the OTC derivatives markets. The evaluation is carried out in three parts: first, by identifying the gaps in the Corporations Law regimes, second by determining the extent to which the general criminal and consumer laws are capable of stepping into the breach left open by the Corporations Law and third, by locating the gaps in the supervisory structure by identify the participants who are not subject to any form of supervision by the regulators.

The examination conducted in this thesis of the regimes in Chapters 7 and 8 of the Corporations Law reveals a number of gaps in respect of investor protection. Significantly, the OTC derivatives market, which is by far the larger market compared to the on-exchange derivatives market, is generally unregulated by the Corporations Law. Comparative analysis between the sanctions provisions in Chapters 7 and 8 of the Corporations Law and those in the *Crimes Act 1900* (NSW) and the *Trade Practices Act 1974* (Cth) indicated that whilst these latter Acts have the potential to act as a substitute for some of the sanctions provisions in the Corporation Law, about half of the sanctions provisions under the Corporations Law regime has no equivalent provisions in these Acts. In consequence, some regulatory gaps remain. Gaps also occur in the supervisory structure as the surveillance by regulators of market participants is focused along institutional lines.

The failure of the law to provide adequate protection to investors trading in the OTC derivatives markets is due primarily to an outdated, inflexible and inappropriate regulatory framework which, when originally constructed, was not intended to regulated the broad spectrum of financial derivatives. This thesis discusses the gaps and deficiencies in the Corporations Law regime and also discusses the recent recommendations made by the Wallis Committee and the Companies and Securities Advisory Committee as well as the proposals of the Treasury in relation to investor protection. It also provides some suggestions for law reform.

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CONTENTS

Synopsis i
Certificate of Authorship of Thesis ii
Acknowledgments iii
Table of contents iv
Table of cases xii
Table of statutes xiv

CHAPTER ONE
INTRODUCTION
1.1 Overview of aim, context of study and significance 1
1.2 Organisation of thesis 6
1.3 Historical development 7
1.3.1 Over-the-counter derivatives 8
1.3.2 Origins of exchange traded derivatives 10
1.3.3 Development of derivatives regulation 12
1.3.4 Securities regulation 12
1.3.5 Futures regulation 14
1.3.6 Licensing of brokers 17
1.4 Defining the parameters of the thesis and Questions investigated 17
1.5 The thesis 18

CHAPTER TWO
METHODOLOGY
2.1 Introduction 20
2.2 Outline of the approach taken and collection of data 22
2.2.1 Analysis of gaps in the Corporations Law 23
2.2.2 Analysis of gaps in consumer and criminal laws 23
2.2.3 Analysis of gaps in the supervisory structure 25
2.3 Rationale for the method adopted 26
2.4 Limitations 33
2.5 Conclusion 34

CHAPTER THREE

OVERVIEW OF DERIVATIVES

3.1 Introduction 36

3.2 What are derivatives? 38

3.3 Classification of derivatives 39

3.4 Uses of derivatives 41

3.4.1 Reasons for growth of derivatives 43

3.5 Basic derivatives 45

3.5.1 Futures 45

3.5.2 Forwards 46

3.5.3 Options 47

3.5.4 Swaps 48

3.6 Risks associated with derivatives 48

3.6.1 Credit risks 48

3.6.2 Market risks 51

3.6.3 Legal risks 54

3.6.4 Operational risks 60

3.6.5 Settlement risks 62

3.6.6 Valuation risks 63

3.6.7 Contagion risks 63

3.6.8 Systemic risks 63

3.7 Conclusion 66

Figure 1 Classification of derivatives 40

Figure 2 Derivatives products 41

CHAPTER FOUR

OUTLINE OF THE REGULATORY FRAMEWORK AND NATURE OF DERIVATIVE REGULATION

4.1 Introduction 67

4.2 An overview of the OTC regulatory framework 68

4.2.1 Corporations Law 69

4.2.2 General regulation 69

4.2.3 Prudential regulation 70

4.3 Nature of regulation 71

4.3.1 Meaning of Terms 71

4.3.1.1. Regulation 71

4.3.1.2 Investors 74

4.3.2 Goals of derivatives regulation 74
4.3.3 Justification for regulation 76
4.3.4 Regulatory tools for investors' protection 80
4.3.4.1 Disclosure 80
4.3.4.2 Licensing 82
4.3.4.3 Prudential requirements 83
4.3.4.4 Prohibition of undesirable market practices 83
4.3.4.5 Suitability rule 83
4.4 Conclusion 84
Figure 3 The Regulatory Framework for Derivatives 69

CHAPTER FIVE
IDENTIFYING THE GAPS IN CHAPTERS 7 AND 8 OF THE CORPORATIONS LAW

5.1 Introduction 87
5.1.1 OTC derivatives contracts 87
5.2 OTC derivative contracts regulated by the Corporations Law and regulatory gaps 88
5.2.1 The definition of "securities" 89
5.2.1.1 Units of shares 89
5.2.1.2 Prescribed interests 89
5.2.1.3 Chapter 7 option contracts 90
5.2.2 The definition of "futures contract" 91
5.2.2.1 An eligible commodity agreement 91
5.2.2.2 An adjustment agreement 92
5.2.2.3 A futures option 92
5.2.2.4 An eligible exchange-traded option 93
5.2.3 Problems of definitions 93
5.2.4 Scope of derivatives regulation and regulatory gaps 95
5.2.4.1 OTC futures contract exempted under section 1127 95
5.2.4.2 "Futures contract" not excluded under paragraph 72(1)(d) 96
5.2.4.3 Futures contracts traded among members of a corporate group 96
5.2.4.4 Contracts prescribed under sections 72A or 92A 97

5.3 OTC derivative contracts not regulated by the Corporations Law 97
5.3.1 Contracts within paragraph 72(1)(d) of the Corporations Law 99
5.3.2 Contracts excluded by regulation made pursuant to paragraph 72(1)(e) 101
5.4 Effect of regulatory gaps on market risks 102
5.5 Effect of regulatory deficiencies on credit risks 103
5.6 Regulatory gaps and legal risks 104
5.6.1 Criminal liability 104
5.6.2 Unenforceable contracts 105
5.6.3 An unlevel playing field 111
5.7 Conclusion 111

CHAPTER SIX
IDENTIFYING THE GAPS IN CRIMINAL AND CONSUMER LEGISLATION
6.1 Introduction 113
6.2 Offences peculiar to the futures and securities markets 117
6.2.1 Dealing by broker on behalf of others (section 1258 of the Corporations Law) 117
6.2.2 Sequence of transmission and execution of orders (section 1266 of the Corporations Law) 118
6.2.3 Insider dealing or trading (sections 232(5), 1002G, 1013, 1253 and 1254 of the Corporations Law) 120
6.2.4 Hawking (section 1078) 123
6.3 Manipulative conduct 123
6.3.1 market manipulation (sections 997 and 1259 of the Corporations Law) 124
6.3.1.1 Examples of undesirable market conduct 124
6.3.1.2 Applicability of TPA 126
6.3.1.3 Applicability of the Crimes Act 132
6.3.2 false trading and market rigging (sections 998 and 1260) 134
6.3.2.1 Examples of undesirable market conduct 134
6.3.2.2 Applicability of TPA 136
6.3.2.3 Applicability of the Crimes Act 137
6.3.3 False or misleading statement (sections 999, 1261) 139
6.3.3.1 Applicability of TPA 140
6.3.3.2 Applicability of the Crimes Act 140

6.3.4 fraudulently inducing dealings (sections 1000 and 1262) 142
6.3.4.1 Applicability of TPA 143
6.3.4.2 Applicability of the Crimes Act 143
6.3.5 Dissemination of information about illegal transactions (sections 1001, 1263) 146
6.3.5.1 Applicability of TPA 146
6.3.5.2 Applicability of the Crimes Act 147
6.3.5.3 Gap in the Crimes Act and TPA 149
6.4 Fraudulent conduct 149
6.4.1 Fraud in connection with dealings in futures contracts (section 1264) 150
6.4.1.2 Applicability of TPA 151
6.4.1.3 Analysis of the Crimes Act 151
6.5 Conclusion 152
Figure 4 Comparative table of sanctions 116

CHAPTER SEVEN

GAPS IN SUPERVISORY FRAMEWORK

7.1 Introduction 154
7.1.1 Overview of supervisory structure 154
7.2 The regulators for the OTC markets 157
7.2.1 The Reserve Bank of Australia 157
7.2.2 The Insurance and Superannuation Commission 158
7.2.3 The Australian Financial Institution Commission 160
7.2.4 The Australian Securities Commission 161
7.2.5 The Australian Competition and Consumer Commission 163
7.3 Gaps arising from the supervisory structure 164
7.4 Conclusion 166
Figure 5 Regulators of the OTC derivatives markets 156

CHAPTER EIGHT

IDENTIFYING GAPS AND TRYING TO CLOSE THEM: RECENT DEVELOPMENTS IN ENSURING INVESTOR PROTECTION IN RELATION TO OTC DERIVATIVES

8.1 Introduction 167
8.2 A summary of significant findings 168
8.2.1 Gaps in the Corporations Law 168

8.2.2 Shortcomings of the Corporations Law regime arising from definitions 169

8.2.2.1 Dated and inflexible 170

8.2.2.2 Complexity 170

8.2.2.3 Definitions give rise to legal uncertainty 170

8.2.2.4 Underlying inconsistency in approach for excluding contracts from being a futures contract 170

8.2.3 Gaps and inconsistencies in the sanctions regimes of the Corporations Law 171

8.2.4 Gaps in the sanctions regime which cannot be filled by the Trade Practices Act 1974 (Cth) and Crimes Act 1900 (NSW) 172

8.2.5 Gaps in the supervisory framework 173

8.3 Major implications of findings 174

8.3.1 Unregulated products 175

8.3.1.1 Sanctions regime 175

8.3.1.2 Intermediaries 175

8.3.1.3 Derivatives market authorisation 177

8.3.2 Unregulated entities 178

8.3.3 Implications of gaps in the Corporations Law on trading risks 180

8.3.3.1 Market risks 180

8.3.3.2 Credit risks 180

8.3.3.3 Legal risks 181

8.3.4 Unsuitable regulatory framework 185

8.3.4.1 Inappropriateness of the Corporations Law structure 186

8.3.4.2 Deficiencies in institutional regulation 188

8.4 Proposed changes to regulators 189

8.4.1 Australian Prudential Regulation Commission 189

8.4.1.1 APRC and the perceived difficulties of the Wallis vision 190

8.4.1.2 A possible solution? 192

8.4.2 Corporations and Financial Services Commission 193

8.4.2.1 CFSC and the difficulties in the Wallis recommendation 196

8.4.3 Conclusion on Wallis recommendations on regulators 197

8.5 Treasury's proposals for law reform 197

8.5.1 Outline of Position Paper 198

8.5.2 Addressing the gaps in the Corporations Law 199
8.5.3 Addressing the gaps in the sanctions regime of the Corporations Law 203
8.5.4 Addressing the gaps in the supervisory structure 204
8.5.5 Conclusion on Treasury's Position Paper 206
8.6 Conclusion 208
Figure 6 208

CHAPTER NINE

CONCLUSION

9.1 Introduction 211
9.2 Research questions 211
9.2.1 Whether adequate regulatory measures exist to deal with the risks inherent in derivative trading, including market risks, credit risks and legal risks 211
9.2.2 Does the regulatory regime adequately address unfair practices and other misconduct? 213
9.2.3 Should all intermediaries be licensed so as to ensure proper oversight of their activities by a regulatory agency? 214
9.2.4 Should derivative traders be required to observe capital adequacy and other prudential requirements? 215
9.2.5 Whether OTC derivatives traders have adequate investors protection under the Corporations Law 216
9.3 Inadequacy of current regulatory structure 217
9.4 To regulate or not to regulate? 218
9.5 Law reform for the Corporations Law 221
9.5.1 Factors relevant to law reforms 221
9.5.2 A minimalist approach to law reforms 224
9.5.2.1 Chapters 7 and 8 of the Corporations Law 226
9.5.2.2 Definitions 227
9.5.2.3 Gaps and inconsistencies in the sanctions regimes of the Corporations Law 229
9.5.2.4 Licensing 230
9.5.2.5 Suitability rule 230
9.5.2.6 Unregulated entities 230
9.5.2.7 Prudential regulation 231
9.5.2.8 Retail investors and exempt market status 231

9.5.2.9 Contravention of gaming and wagering laws 231
9.5.2.10 Ultra vires principle 231
9.5.2.11 Insolvency laws 232
9.5.2.12 Regulators 232
9.6 Conclusion 232

Appendix 1 Analysis of sections 52 and 53 of the *Trade Practices Act 1974* (Cth) 236
Appendix 2 Glossary 251
Appendix 3 Selected Recommendations of the Wallis Committee and proposals of the Treasury for the reform of regulation on financial markets and investment products 261
Appendix 4 Reference list 271

TABLE OF CASES

Anon (1369) Jenk 49 (case xciii), 145 ER 36.
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Queensland

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Western Australia

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CHAPTER 1

INTRODUCTION

'(Derivatives) are regulatory nightmares. They are "off-balance sheet" instruments whose mere existence, leaving aside their complexities, obscures what is going on at the store. They make leverage all too easy to come by. Concocted in unstoppable variations by rocket scientists who rattle on about delta, gamma, rho, theta and vega, they make total hash out of existing accounting rules and even laws. Tellingly, the laws of many countries have considered some derivative contracts to be gambling bets, in the sense that the outcome of the transaction is not under the control of either party to it.'[1]

1.1 Overview of context of study and significance

This thesis examines and evaluates the regulatory regime governing over-the-counter (OTC) derivatives in Australia. The objectives are twofold: to gauge whether the existing regulatory regime is adequate to ensure investor protection given the frequent innovations in new derivatives products, their complexity and the risks that are inherent in trading on the OTC derivatives market and to make recommendations for law reform in relation to Chapters 7 and 8 of the Corporations Law for the protection of investors, particularly those at the retail end of the OTC derivatives market.

The focus on financial derivatives is prompted by their growing importance[2] in the world of commerce and by the concern that the use of these products could cause investors to incur losses. The concerns stem, in part, from the rapid growth in the use of derivatives and also, as indicated in the quotation above, a significant increase in "unstoppable variations" of these instruments. There are over a thousand different derivatives now in existence, and new products are continually being developed. Some of these derivatives are highly complex and could cause an investor to incur huge losses through wrong strategies in trading based on inadequate understanding of derivatives. What appears to be the crux of the problem is that the existing regulatory

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[1] See Loomis, CJ, 'The Risk That Won't Go Away', Fortune, March 7, 1994, 40; this was also quoted by Cameron, A, 'Issues For the ASC and Business in the 90s', an address delivered at the Corporate Lawyers and Regulators Forum, at the Hyatt, Coolum, 19 May 1994, 15.

[2] As at the end of 1996 OTC derivatives has a notional outstanding value of nearly US$25 trillion. See Walsh, M, 'MX Missile Lurks in Hidden Deals', *the Sydney Morning Herald*, 11 November 1997, 27.

structure in the Corporations Law was intended primarily for regulating "securities"[3] and "futures contracts"[4] which are traded on exchange. The Corporations Law regime pre-dates the advent of the new generation of derivatives and has not kept pace with recent innovations and developments in financial products, particularly those transacted on the OTC markets.[5] As Todd Petzel[6] observed:

> "In every country, however, it is safe say that the pace and imagination of the markets in building and using derivatives has far outstripped the regulatory framework's ability to adjust."[7]

In consequence, there is concern that some OTC derivatives are totally unregulated.[8]

While it may be argued that there are many advantages to a market unfettered by regulation, the problems to which such an unregulated market give rise include the potential for anti-competitive monopolies, fraud or insider trading. Added to this is a number of other concerns.

Derivatives afford opportunities for financial leverage. As a derivatives instrument generally costs only a fraction of the actual price of the underlying asset, it allows a derivatives investor to make huge profits due to the phenomenon that an increase in the price of an underlying is manifested by a corresponding increases in price of the derivative product. Conversely, it also could cause the investor to incur huge losses. Leverage promotes gambling and speculation and could have disastrous consequences for the investor.

Further, the accounting treatment accorded to some derivatives such as swaps, options, futures and foreign-exchange forwards,[9] merely give rise to contingent liability. As such, they are not generally booked as assets or liabilities and are treated as off balance sheet items. This practice is of concern as it could mask the true

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[3] This term is defined in section 92 of the Corporations Law.
[4] This term is defined in section 72 of the Corporations Law.
[5] This phenomenon is not confined to Australia but is true also for the United States and arguably for other countries; see Petzel, TE, 'Derivatives: Market and Regulatory Dynamics', *The Journal of Corporation Law*, Fall, 1995, 95.
[6] A United States author who was described in the article as the Executive Vice President and Chief Investment Officer of The Common Fund.
[7] Petzel, TE, note 5, 95.
[8] Australian Securities Commission, 'Report On Over-The-Counter Derivatives Markets', 1994 (ASC Final Report), paragraph 66.
[9] McDougall, B, 'For the Younger Banker: Derivatives De-Mystified', *the Australian Banker*, Vol 108 No 2, 1994, 85.

financial position of a company and reduce the transparency of its accounts. The lack of transparency can hide a firms imprudent use of derivatives.

A major worry is the potential for a systemic crisis due to market linkages and concentration.[10] Linkages are natural feature of the derivatives market as a derivatives contracts are derived from their underlying or physical contracts and therefore derivatives markets are closely interlinked or interconnected with their physical or underlying markets. In Australia, there appears to be a considerable volume of dealings among intermediaries and the OTC market is concentrated in a handful of participants.[11] Such concentration and linkages can have very adverse consequences on the capital markets should a major participant fail. The insolvency of a large financial institution could set the scene for a systemic crisis, by being the catalyst which sets in motion a chain reaction, bringing down other institutions.[12]

Risks involved in derivatives trading have been highlighted by a spate of spectacular losses in recent years by corporations world-wide such as Kidder Peabody in the United States,[13] Daiwa Bank in Japan,[14] AWA in Australia,[15] Proctor and Gamble in the United States,[16] Metallgesellschaft in Germany,[17] Baring Pic, an English merchant

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[10] Linkages is explained in paragraph 3.6.8 of this thesis. See also United States House of Representatives, *Review of Reports by the US General Accounting Office and the Commodity Futures Trading Commission on Derivative Products*, a hearing before the Subcommittee on Environment, Credit and Rural Development of the Committee on Agriculture at the One Hundred and Third Congress, Second Session, June 14, 1994, US Government Printing Office, Washington, Serial No 103-75 (US Derivatives Review), and in particular the testimony of James Boothwell, of the General Accounting Office, 8.

[11] ASC Final Report, note 8, paragraph 22. This Report, at Table 4, showed that the number of participants accounting for 50% of market volume did not exceed 5, for each of the main product groups in OTC derivatives markets. The data was drawn from the 1992 Australian Financial Markets Association survey. The position in the United States is the same. It is reported in the US Derivatives Review, note 10, (at 8) that the top five US securities firms dealing in OTC derivatives accounted for about 87% of total derivatives activities for all US securities firms.

[12] Loomis, CJ, note 1.

[13] See the discussion on this company in Zweig, P, et al., 'Risk - The New Way of Managing It', *Financial Review*, 31 October 1994, 13.

[14] Daiwa Bank executives in New York were charged with concealing US$1.1 billion in trading losses generated mainly through the bond futures markets: See the Special Report: 'Derivatives - US Industry Survives Scandals With Amazing PR Triumph', *Financial Review*, 31 January 1996, 23; Bloomberg, 'Daiwa Bank Case Postponed to Get Witness Statements', *The Australian*, 9 February 1996, 31; Bloomberg, 'Daiwa Faces Fewer Charges', *Financial Review*, 14 February 1996, 32.

[15] See *AWA* v *Daniels* (1992) 7 ACSR 759 and *Daniels & Ors (formerly practising as Deloitte Haskins & Sells)* v *Anderson & Ors; Hooke* v *Daniels & Ors (formerly practising as Deloitte Haskins & Sells); Daniels & Ors (formerly practising as Deloitte Haskins & Sells)* v *AWA Ltd*, (1995) 13 ACLC 614. AWA was reported to have lost $49 million on forward exchange contracts.

[16] Proctor and Gamble announced losses of US$102 million for the year ended 30 June 1994. The losses were attributable to leveraged swap transactions. See Sydney Futures Exchange Limited, 'Surviving With Derivatives: What Directors Need To Know', June 1995, 5.

[17] The loss of US$1.3 billion was in fact sustained by MG Corporation, the US subsidiary of Metallgesellschaft A.G., Germany's fourteenth largest industrial firm. The huge loss was incurred in taking a position in energy futures and swaps. See Edwards, FR & Canter, MS, 'The Collapse of

bank, in Singapore,[18] and more recently by Union Bank of Switzerland which reportedly incurred a loss of US$140 million in the first half of 1997.[19] The potential for negative effects of trading in derivatives are not limited to corporations. The well publicised insolvency of the Orange County in California was attributable to over-leveraged derivatives trade resulting in a loss to the municipality of US$2.2 billion.

Losses such as these have caused uneasiness in the global financial markets and among regulators worldwide. They have brought into focus the question as to whether the existing regulatory framework has the capacity to provide adequate protection to investors, particularly retail investors. Such a question can be answered only by first examining and evaluating the adequacy of the current regime in regulating OTC derivatives and identifying the weaknesses in the system.

This thesis is significant in several respects. First, the study is timely in that derivatives regulation is very much a topical issue which currently preoccupies regulators worldwide. End users, academics and regulators worry that OTC derivatives may cause the next great banking crisis.[20] The concern has been sufficiently grave as to warrant major governmental studies being conducted into the risks posed by derivatives. In Australia alone, a number of key papers and reports have been released. These include a number of publications by the Australian Securities Commission, a series of reports by the Companies and Securities Advisory Committee and a report by the Parliamentary Joint Committee on Corporations and Securities. More recently, at the end of 1996, the Government announced an action plan, inter alia, for examining the appropriate level of regulation of OTC markets, under its Corporate Law Economic Reform Program. Since that announcement, the Wallis Committee's Financial System Inquiry Final Report, the Companies and Securities Advisory Committee's 'Regulation of On-Exchange and OTC Derivatives Markets, Final Report' and, as this thesis is being prepared for submission, the Commonwealth Treasury's position paper on the Regulation of the Securities and Derivatives Markets

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Metallgesellschaft: Unhedgeable Risks, Poor Hedging Strategy, or Just Bad Luck?', *The Journal of Futures Markets: Futures, Options and Other Derivative Products*, Vol 15 No 3, May 1995, 211; see also Sydney Futures Exchange Limited, note 16, 5.

[18] The loss of S$2.2 billion was due to unauthorised trading by Nick Leeson in Nikkei Futures and in JGB Futures (a long term Japanese Government Bond futures). See Lim, M & Tan, N, *Baring Futures (Singapore) Pte Ltd: The Report of the Inspectors Appointed by the Minister for Finance*, Ministry of Finance, Singapore, 1995, 29; The Economist, 'Rogue Trader', Focus, *Weekend Australian*, 4-5 March 1995, 29; Parliamentary Joint Committee on Corporations and Securities, *Report On Derivatives*, Senate Printing Unit, Parliament House, Canberra, 1995, 3.

[19] The Union Bank's loss was due to trading in equity derivatives, that is, options and other contracts tied to stocks and stock indexes. See Bloomberg, 'Derivatives Loss Trims UBS Staff', *the Australian Financial Review*, 21 November 1997, 50.

[20] Hu, H, 'Misunderstood Derivatives: The Causes of Informational Failure and the Promise of Regulatory Incrementalism', *Yale Law Journal*, Vol 102, No 6, 1457-1513, April 1993, 1457.

have made their appearance. The raft of reports supports the view that this work is timely.

Second, identifying the gaps and other deficiencies in the Corporations Law regime and mapping out the extent to which other pieces of legislation are or may be effective substitutes, will help to obviate the need for any unnecessary regulation for the protection of investors in the OTC markets. This will reduce the cost of regulation.

Third, the study will hopefully help to lay the groundwork for law reforms[21] and contribute to the development of a better regulatory regime. This is important because deregulation of global financial systems has made mobile a very large and very liquid pool of international investment funds[22] and created substantial opportunities for domestic markets. The ability of a domestic market to garner a portion of those funds will depend largely on how competitive it is in the international arena. Even on a modest scale, a national market which operates in a conducive regulatory environment would be in a good position to retain not only its own domestic derivatives trade, but would have the potential to attract a portion of the regional business from less competitive neighbouring capital markets.

Fourth, this thesis contributes to the development of a more effective regulatory regime, by advocating a model which affords comprehensive investor protection but through minimalist approach to regulation thus reducing costs of regulation and at the same time offering extensive investor protection by filling up the regulatory gaps. Such a model is expected to promote a higher volume of commercial activities and consequently add greater depth and liquidity[23] to the derivatives markets, thus reducing not only the costs of transactions but also the risk of failure due to an illiquid market.

Fifth, this thesis has identified gaps and other weaknesses in the regulatory structure which, if addressed, could lead to greater regulatory and legal certainty. For example, a derivatives contract which contravenes gaming and wagering legislation of a State would be unenforceable under general contract law as being void for illegality. Contracts governed by the Corporations Law are protected from the consequences of illegality by virtue of sections 778 and 1141 of the Corporations Law. However, as

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[21] Corcoran, S, 'Comparative Corporate Law: Research Methodology', *Canberra Law Review*, Vol 3 No 1 1996, 54, at 56.
[22] Smith, R C & Walter, I, *Global Financial Services: Strategies For Building Competitive Strengths in International Commercial and Investment Banking*, Harper Business, New York, 1990, 443.
[23] 'Liquid' here is equated with 'active'. A liquid market has a tendency to attract more traders and investors. See Sydney Futures Exchange Limited, 'Demystifying Derivatives', undated, 1.

has been established by this thesis, some OTC derivatives contracts are excluded from the Corporations Law mainly because of the inappropriateness of the definitions in the current regime. Investors who buy or sell unregulated derivatives are not entitled to the benefit of protective provisions in that regime. Addressing the deficiencies in the Corporations Law will reduce not only the legal risks associated with the use of these instruments, but credit and market risks as well.[24] This will enhance investor protection.

1.2 Organisation of this thesis

The thesis is divided into nine Chapters. This introductory Chapter sets out, in brief, the aim of the thesis, its parameters, its significance and an outline of each Chapter. In order to have a better appreciation of the concerns associated with the use of financial derivatives, it is necessary to review their historical development. For this reason, a brief historical sketch of derivative markets as well as an outline of the development of securities and futures regulation in this country have been included in this Chapter. Finally, the Chapter lists the research questions which are to be investigated. These questions aid in the evaluation process by providing a focus on the adequacy of the existing system.

The next Chapter sets out the methodology for a detailed analysis of the existing framework for regulating OTC contracts. Its main objective is to describe and advocate the adoption of a multi-disciplinary model for the examination and evaluation of the regulatory framework. The benefits of borrowing insights from a variety of disciplines are discussed. So, too, are limitations of individual disciplines. Chapter 2 also locates this work in the context of earlier reports on the regulation of OTC derivatives and provides the rationale for this study.

Background information on financial derivatives is provided in Chapter 3. It provides an overview of what derivatives are, their classification and functions. Of significance is the discussion of the risks: market, credit, legal, operational and systemic as they provide the justification for regulating the OTC derivatives market so as to afford investor the protection they require.

As the thesis is about the regulation of OTC derivatives, it is important that the existing regulatory structure be understood at the outset. Equally important is a consideration of the nature of derivatives regulation. Therefore, following the presentation of the background information in Chapter 3, Chapter 4 provides an

[24] Chapters 5, 8 and 9 of the thesis discussed how gaps and deficiencies increase these risks and how addressing the deficiencies could reduce the risks.

outline of the regulatory framework. It also deals with the nature of regulation and discusses some regulatory strategies for protecting investors.

Chapters 5, 6 and 7 comprise the centrepiece of the thesis. These Chapters examine, analyse and evaluate the regulatory structure and identify the regulatory gaps in the Corporations Law and in the supervisory framework. Chapter 5 is concerned with the gaps and inadequacies in the Corporations Law, Chapter 6 with the *Trade Practices Act 1974* and the *Crimes Act 1900 (NSW)* and Chapter 7 with the deficiencies in the supervisory structure.

Chapter 8 summarises the principal findings of this work and discusses the major implications of those findings. Recent reports of the Wallis Committee and the Companies and Securities Advisory Committee on the financial system and the derivatives markets are highlighted and an evaluation made of the recommendations of these committees in so far as they relate to investor protection in the OTC derivatives market.

The release by the Treasury of its policy paper entitled, 'Financial Markets and Investment Products', on 21 December 1997 prompted the inclusion in Chapter 8 of a discussion of key proposals in the Treasury's paper to determine the extent to which they have the capacity of remedying the deficiencies which have been identified in this thesis in relation to the regulatory structure.

The concluding chapter revisits the research questions identified in Chapter 1 and summarises the discussions of those questions. Recommendations for law reforms are also made. Taking into consideration the changing nature of financial derivatives, and the likelihood of regulation being rapidly outdated by the changes, this thesis argues for a minimalist approach to law reform as an interim measure until the metamorphic process stabilises.

The problems and issues confronting the regulators today are a product of the development and evolutionary process of financial derivatives and as alluded to above, of the regulatory system's failure to cope with the pace of innovation in the capital markets. The next section of this Chapter reviews the historical development of derivatives and the regulation of securities and futures contracts.

1.3 Historical development

Existing regulations on derivatives are largely dependent on whether the products are traded on organised exchanges or in the OTC markets. Whilst exchange traded

derivatives are governed mainly by Chapters 7 and 8 of the Corporations Law, and the business rules of the exchanges and the clearing houses, OTC instruments enjoy a more relaxed regulatory environment. Some OTC products may be within the purview of the Corporations Law, but a number of them are not. For that reason, it is thought that it would be appropriate to divide the historical outline into two sections, with a section devoted to tracing the origins of both on-exchange and OTC markets and a second section to tracing the origins of derivatives regulation.

1.3.1 *Over-the-counter derivatives*

Of the two classes of derivatives, the OTC variety has a longer history. It is said that the first forward market[25] existed in India around 2000 BC[26] and that forward contracts[27] were recorded in sixth century BC in Greece.[28] Then in the twelfth century, "lettres de faire", a kind of forward agreement, made their appearance at medieval fairs in Flanders and in England.[29] Merchants sold their goods at the fairs on the basis of samples. The price was fixed at the time the agreement was made and before the goods arrived by ship.

The modern day OTC forward market became active in early 1970s following the floating of major currencies which saw banks entering into spot and forward contracts on the interbank market basically to seek protection against currency volatility. The growth in the forward market was aided by swaps which in turn stimulated the development of other OTC derivatives such as options.[30]

Swaps originated from the United States with the first known currency swap occurring in 1979. This was followed by interest rate swaps which were transacted in England and which later on were adopted by businesses in the United States.[31] Early swaps were hedged by matching two identical but opposing swaps. The technique for risk management is much more sophisticated today with swaps being hedged by combining

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[25] A forward market is a market where forward contracts, a significant group of financial derivatives, are traded. A forward market is distinguished from a futures market in that contracts traded on a forwards market are traded over-the-counter while those on a futures market are standardised exchange traded contracts.

[26] Winstone, D, *Financial Derivatives: Hedging With Futures, Forwards, Options & Swaps*, Chapman & Hall, London, 1995, 60.

[27] A forward contract is explained in paragraph 3.5.2 of this thesis.

[28] Slatyer, W & Carew, E, *Trading Asia-Pacific Financial Futures Markets*, Allen & Unwin, St Leonards, NSW, 1993, 45.

[29] Winstone, D, note 26, 60.

[30] See Chance, DM, *An Introduction To Derivatives*, 3rd ed., The Dryden Press, Florida, 1995, 228-29; for a detailed account, see Galitz, L, *Financial Engineering: Tools and Techniques to Manage Financial Risk*, Pitman Publishing, London, 1995, 142-49.

[31] Chance, DM, note 30, 499.

positions in spots, futures, swaps, forwards bond futures and other derivative products.[32]

In Australia, the OTC forward market became active only after 1984. Prior to that date, it was a controlled market with banks being permitted to enter into forward exchange contracts with their customers only if certain conditions were met. For instance, such contracts were permitted, provided they were used to cover exchange risks associated with trade and entered into within seven days of the risks being incurred.[33] The floating of the Australian Dollar in December 1983 was the catalyst which caused the removal of the "trade only" restriction. With the dismantling of exchange controls, the Australian currency was subjected to some sharp fluctuations. To reduce volatility, the Government responded by removing the restriction on forward exchange contracts. The Government's move to increase the number of foreign exchange dealers in 1984 provided depth to the market.[34]

Development of the currency hedge market in Australia took place in the 1970s. The currency hedge market is used as an alternative to the banks' foreign-exchange market. Before 1970, there was little incentive for the development of this market as both interest rates and currency exchange rates were stable. This stability was shaken in the 1970s with the market experiencing much greater volatility on currency exchanges and on interest rates as a consequence of a credit squeeze and the sharp increases in oil prices. Although initially the preserve of non-banking sector, this changed in 1979 with the entry of trading banks in the currency hedge market.[35]

OTC derivatives contracts have evolved in complexity over the years. Initially, banks and other intermediaries merely acted as brokers between two parties. Later, these intermediaries acted as principal in respect of swaps and other derivatives for which they did not have a suitable counterparty and temporarily hedged whatever risk that arose with a cash, securities or futures position. Finally, the transition was made to a portfolio approach where each transaction was decomposed into its component cash-flows and the various aggregated risk elements managed separately.[36] This was made possible by the Black-Scholes[37] and other models.

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[32] Galitz, L, note 30, 149.

[33] See Carew, E, *Fast Money 2: The Money Market in Australia*, George Allen & Unwin, Sydney, 1985, 160.

[34] See Carew, E, *Fast Money 2;* note 33, 160-61.

[35] See Carew, E, *Fast Money 2;* note 33, 163-64.

[36] Malaysian Securities Commission, 'Malaysia: Aspects of Operational Risks', *Business Times*, May 24, 1995, 4.

[37] This is an option pricing model developed by Professors Fischer Black and Myron Scholes of the United States, and was regarded as a major breakthrough in the measurement of financial risks. The

1.3.2 ***Origins of exchange traded derivatives***

Japan is credited with the development of the world's first futures market, the Doljima Rice Market. Rice in the Osaka area was traded for future delivery in the seventeenth century during the Tokugawa Shogunate.[38] In 1730, the Tokugawa Shogunate established rules for "rice trade on book market place".[39]

However, it was not until the Chicago Board of Trade was established that the world finally had its modern exchange traded futures market. Established in 1848 in connection with the grain markets,[40] it dealt initially on spot trades. This was subsequently expanded to include forward "to arrive" contracts. These forward "to arrive" contracts were agreements for the sale or purchase of grains and the physical commodity was intended to be delivered.[41] A practice was later developed whereby the agreements were sold and resold and for this reason the forward "to arrive" contracts have been credited with being the first futures contracts.[42] By 1865, the Chicago Board of Trade had established trading rules known simply as "General Rules". Close on the heels of the Chicago Board of Trade, a number of other commodity exchanges were developed in the United States. These included the Mid-American Commodity Exchange in 1868, the New York Cotton Exchange in 1870, the New York Mercantile Exchange in 1872 and the New York Coffee Exchange in 1885.[43]

The evolution from commodities exchange to financial futures exchange began in the 1970s. The removal of fixed currency exchange rates by major economies at the commencement of that decade gave rise to the formation of the International Monetary Market in 1972, to trade in futures contracts on foreign currencies. This was followed in 1975 by futures contracts on interest rates which was made available by the Chicago Board of Trade, in 1976 by the first futures contract on government securities, in 1977 by the US Treasury bond futures and in the 1980s by stock index futures contract.[44]

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model provides a single formula which enables the fair price for a call option to be calculated.

38 Winstone, D, note 26, 60; Slatyer, W & Carew, E, note 28, 46.

39 This term appears to be an Anglicised version of the Japanese "Cho-ai-mai-kaisho". See Slatyer, W & Carew, E, note 28, 46.

40 Winstone, D, note 26, 61

41 Winstone, D, note 26, 61; see Chance, DM, note 30, 227 for a more detailed account of the "to arrive" contract.

42 Winstone, D, note 26, 61.

43 Slatyer, W & Carew, E, note 28, 47.

44 Chance, DM, note 30, 227-8.

In Australia, the starting point for exchange traded derivatives is the Sydney Futures Exchange. The origins of exchange traded futures may be traced back to the Sydney Greasy Wool Futures Exchange which became an organised futures market in 1960 and commenced trading in wool on 11 May of that year.[45] Fifteen years later, it began trading in cattle contracts, followed in 1978 by gold futures contracts. In February, 1976, the Australian Stock Exchange, Derivatives, established its options market known as the Australian Options Market.[46] Trading was confined to call options over four stocks and put options were included in 1982.[47]

The late 1970s and the 80s saw a range of financial futures contracts being introduced on the Sydney Futures Exchange. These included a 90 day bank bills futures contract on 17 October 1979,[48] currency futures contract denominated in United States Dollars, Yen and then Sterling in 1980, a contract based on the All Ordinaries share price index in 1983, a two-year government bond and a ten year government bond in 1984.[49] Since then, a variety of other futures have made their appearance. There is now traded on the exchanges short term interest rate derivatives such as Forward Rate Agreements (FRA's), Bank Bill futures and swaps, long term interest rate derivatives such as ten year bond futures and options as well as three year bond futures and options swaps and equity derivatives such as share futures, All Ordinaries share price index futures and options, share options, Low Exercise Price Options[50] (commonly known by its acronym LEPO) and Share Ratios Options.[51]

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[45] Currie, JS, *Australian Futures Regulation,* Longman Professional, Melbourne, 1994, 2.

[46] Sum, R, 'Exchange-traded Equity Options: Market Structure and Participation', *Journal of Banking and Finance Law and Practice*, Vol 7, 1996, 5.

[47] Sum, R, note 46.

[48] This bill was discussed by Lindgren J in *Sydney Futures Exchange Limited* v *Australian Stock Exchange Limited and Australian Securities Commission (Intervener)* Fed No 86/95 (1995) 3 ACLC 369, hereinafter referred to as "SFE v ASX (1995)" at paragraph 83.

[49] Currie, JS, note 45, 64-65.

[50] For a comprehensive discussion on LEPO, see SFE v ASX (1995), note 48. In this case, Lockhart J explained a LEPO as an option contract which is extremely deep in the money and which typically, has "an exercise price of between 1 and 10 cents and have a European expiry, that is they can only be exercised on the last trading day... LEPOs (are) deliverable contracts usually covering 1,000 shares of the underlying stock."; See also *Sydney Futures Exchange Limited* v *Australian Stock Exchange Limited* Fed No 798/94 (1994) 12 ACLC 1,015 (hereinafter referred to as SFE v ASX (1994)); ASC Media Release ASC94/110 dated 23 June 1994 and Heinrich, K, "SFE finally delivers on futures contract", *The Australian*, 12 March 1996, 54.

[51] See Donnan, F, 'The Share Ratio Act: Innovation or Experimentation in Securities Regulation?', *Companies and Securities Law Journal*, Vol 14, 1996, 101; Frank Donnan described a share ratio as "a measure of relative share performance. It measures the relative performance of an individual share against the performance of the all ordinaries share price index over a period of time. A share ratio is determined by dividing the price of the relevant share in cents by the all ordinaries index and multiplying this figure by 1,000." See also Wilson, C, "A Guide to Share Ratios", *Canberra Times*, 18 February 1996, 11; Carew, E, *Derivatives Decoded,* Allen & Unwin, Sydney, 1995, 133.

1.3.3 *Development of derivatives regulations*

The current regulation of financial derivatives is not a discrete regime but is comprised of the regimes governing securities and futures. This is because apart from futures, other derivatives products have not been subjected to derivatives-specific regulation.[52] As the underlying assets of derivatives include securities and because futures regulation was modelled largely on securities regulation, an historical review of derivatives regulation should include not only futures, but also securities.

1.3.4 *Securities Regulation*

The regulation concerning financial derivatives in Australia may be traced to the introduction of legislation to regulate the securities industry in 1970 in New South Wales, Victoria, Queensland and Western Australia. Before 1970, exchanges were not subject to any legislation.[53] Government regulation of exchanges in Australia is relatively new with the stock exchange in New South Wales being the first to come under legislative control with the enactment of the *Securities Industry Act 1970* (NSW). This was followed by similar Acts in other States,[54] namely Western Australia, Queensland and Victoria.[55]

This early legislation contained important safeguards for investors including provisions which proscribed short selling, market fictions, market rigging and spreading false rumours.[56] The legislation also provided for the licensing of dealers and investment advisers, the regulation of stock exchanges, the auditing of stockbrokers and dealers accounts, the maintenance of a fidelity fund,[57] all of which were calculated to maintain investor confidence in stock exchanges and securities markets.

The 1970 securities legislation was repealed and succeeded in 1975 by uniform securities industry legislation, again in the same four States of Western Australia, New South Wales,[58] Queensland and Victoria.[59] The 1975 uniform legislation saw the establishment of the Corporate Affairs Commission[60] in the States and the inclusion of important provisions aimed at investor protection and the orderly and fair conduct of

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52 Since 1979, futures contracts have been subjected to Government regulation.
53 Baxt, R, et al., *Stock Markets and the Securities Industry - Law and Practice*, Butterworths, Sydney, 1988, 60.
54 SFE v ASX (1995), note 48, per Lindgren J at paragraph 62.
55 Baxt, R, et al., note 53, 17 & 60.
56 See Baxt, R, et al., note 53, 17.
57 See Baxt, R, et al., note 53, 17.
58 In New South Wales, the Act is known as the *Securities Industry Act, 1975* (NSW).
59 Baxt, R, et al., note 53, 17.
60 Baxt, R, et al., note 53, 17.

the securities market. Investor protection provisions include the licensing of dealers and investment advisers, the auditing of stockbrokers and dealers accounts, maintenance of a fidelity fund while fair and orderly market provisions prohibit such practices as short selling, false rumours, market fictions and market rigging.

Investor protection remained very much the focus of legislators as is apparent in the Formal Agreement dated 22 December 1978 made between the Commonwealth and the six States of Australia where it was recited that:

> "WHEREAS -
>
> (A) it is generally acknowledged in the interests of the public and of persons and authorities concerned with the administration of the laws relating to -
>
> (a) companies; and
>
> (b) the regulation of the securities industry,
>
> that there should be uniformity both in those laws and in their administration in the States and Territory of Australia in order to promote commercial certainty and bring about a reduction in business costs and greater eff.ciency of the capital markets and that the confidence of investors in the securities market should be maintained through suitable provisions for investor protection."[61]

However these goals in the Formal Agreement may be subsumed under two mains heads, namely(an efficient market (with the goal of reduction of business costs and greater efficiency) and investor protection, (encompassing promotion of commercial certainty and investors' confidence). Such a classification seems to be consistent with the views expressed by Robert Baxt and others[62] that,

> "(I)nvestor protection is one of the two key objectives of the National and Securities Commission (the other being the promotion of an efficient market)."[63]

The aspirations of the Formal Agreement were later encapsulated in the legislation of that scheme. For example, sections 59 and 60 of the *Companies (Acquisition of*

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[61] Formal Agreement dated 22 December 1978 made between the Commonwealth and the States of New South Wales, Victoria, Queensland, South Australia, Western Australia and Tasmania, reproduced in Appendix 1 in Baxt, R, et al., note 53, 249.

[62] Baxt, R, et al., note 53.

[63] .Baxt, R, et al., note 53, 20.

Shares) Act 1980 (Cth), one of the enactments in the national co-operative scheme, deals with investor protection.

These key objectives have been carried over to the *Australian Securities Commission Act 1989* (Cth) which provides in subsection 1(2) that the Commission should strive:

> "(a) to maintain, facilitate, and improve, the performance of companies, and of the securities markets and futures markets, in the interests of commercial certainty, reducing business costs, and the efficiency and development of the economy; and
>
> (b) to maintain the confidence of investors in the securities markets and futures markets by ensuring adequate protection for such investors; and
>
> (c) to achieve uniformity throughout Australia in how the Commission and its delegate perform those functions and exercise those powers; ..."

The subsection shows that present day regulatory goals in Australia have changed little from the days of the early 1980s.

1.3.5 *Futures Regulation*

The futures market grew from infancy as the Sydney Greasy Wool Futures Exchange in the early 1960s and 1970s in an environment which was free from government regulation.[64] It remained entirely self-governing until 1979 when the *Futures Markets Act 1979* (NSW) ("FMA") was enacted to regulate the futures markets.

The FMA was the first Australian legislation to regulate futures trading and futures exchanges. This is hardly surprising given that the country's only futures exchange was then operating in Sydney as Sydney Greasy Wool Futures Exchange Limited (now the Sydney Futures Exchange Limited).

The FMA required that the business rules of futures exchanges and any amendments to those rules had to be approved by the Minister. To remove any uncertainty as to the legality of futures contracts, it was provided in section 7 of the FMA that a futures contract made at a futures market maintained by an approved futures exchange was not a contract by way of wagering or gaming.[65] The FMA did not prohibit the trading of futures contracts by unapproved bodies but the measure of investor protection afforded by section 7 was not available to such unapproved bodies.[66]

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[64] Currie, JS, note 45, 2, 61.
[65] SFE v ASX (1995), note 48, per Lindgren J at paragraph 74.
[66] SFE v ASX (1995), note 48, per Lindgren J at paragraph 75.

The pace of development in the futures market soon rendered the FMA outdated. As the Hon DP Landa, Minister for Energy and Water Resources explained in introducing the Bill which was later to be passed as the *Futures Markets (Amendment) Act 1982*:

> "Originally, the futures market was a rather specialised one of interest mainly to wool producers and users. In recent years, however, the futures market has developed into a large and diverse forum ... (The types of contracts) include not only the more traditional commodity items ... but also financial futures including the United States dollar contract and the bank accepted bills of exchange contract."[67]

More specifically, the FMA was found to be restrictive in some respects. First, it defined a "futures contract" to mean either a commodity futures contract or a currency futures contract. This definition of a commodity futures contract raised doubts as to whether the 90 day bank bill of exchange, introduced in October 1979, just before the enactment of the FMA, constituted a commodity. The meaning of "commodity" which was described as "a specified quantity of a specified commodity" in the definition of "commodity futures contract"

> "suggests a thing quantifiable by weight or volume rather than individual things quantifiable by number".[68]

Second, the definition of a "commodity futures contract" requires delivery. Cash payment was not yet an alternative. As the Minister explained in his second reading speech in the NSW Legislative Council in relation to the FMA,

> "It is an important feature of futures markets that trading is in terms of contracts to deliver or to take delivery, rather than on the immediate transfer of the physical commodity."[69]

Third, the FMA was inflexible in that it did not provide a mechanism by which other derivatives contracts might be brought under the ambit of that Act. Futures contracts which were not within the definition of futures contract would not be governed by the FMA.

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[67] Hansard, Vol 173, NSW Legislative Council, 2 December 1982, 3770-3771, quoted by Lindgren J in SFE v ASX (1995), note 48, at paragraph 84.

[68] SFE v ASX (1995), note 48, per Lindgren J at paragraph 83.

[69] Hansard, Volume 152, NSW Legislative Council, 29 November 1979, 4200 cited by Lindgren J in SFE v ASX (1995), note 48, at paragraph 79.

The *Futures Markets (Amendment) Act 1982* addressed these deficiencies. The Amendment Act sought to enhance investor protection by introducing new definitions such as "commodity" to ensure that interest rate futures, which were traded on the Exchange, were brought under the FMA and, in an attempt to provide a more flexible regime, it introduced a regulation-making power so that new futures contracts could be brought under the FMA.[70]

Despite the improvements made to investor protection, it was considered that the FMA, as amended, was still inadequate, restricted as it was to New South Wales. The investor protection mechanisms in the Business Rules of the Sydney Futures Exchange offered protection only to investors trading on that exchange. While the Exchange had the power to discipline its members it was powerless to protect investors dealing with non-members who would have to seek their remedy by resorting to litigation in situations of default. Further, the Exchange's jurisdiction did not extend to OTC products or to products traded across the border.[71] The problem was summarised in the following passage of the Final Report of the Committee of Inquiry into the Australian Financial System (Campbell Report):[72]

> "The Committee believes that there should be a national approach to the regulation of futures exchanges. In the absence of such an approach, any efforts to regulate the Sydney Futures Exchange could be frustrated if this were to lead to the futures market being relocated in another state where there was no comparable regulation."

The *Futures Industry Act 1986* (Cth) became the first legislative scheme to regulate the futures industry on a national basis. This Act was applied by each of the States[73] and was known in each State as the Futures Industry Code of that State. The Futures Industry Code was the forerunner to Chapter 8 of the Corporations Law and the provisions in Chapter 8 mirrors the provisions of the Futures Industry Code.[74] Thus the futures regulatory framework remains largely unaffected by the appearance of new derivatives instruments. As will be demonstrated in Chapter 5 of this thesis, Chapter 8

[70] Hansard, Vol 173, NSW Legislative Council, 1 December 1982, 3667-3668 quoted by Lindgren J in SFE v ASX (1995), note 48, at paragraph 80.

[71] See the discussion in Currie, JS, note 45, 29-31.

[72] Australian Financial System Inquiry, 'Final Report', Australian Government Publishing Service, Canberra, September 1981, paragraph 21.22. This passage was also quoted in Currie, JS, note 45, 30.

[73] SFE v ASX (1994), note 50, per Sackville J, paragraph 57.

[74] Currie, JS, note 45, 31.

of the Corporations Law does not have the capacity to cope with many of the new derivatives traded on the OTC markets.

1.3.6 *Licensing of brokers*

Licensing of dealers and advisers was a means by which investors were protected. The practice of licensing originated in England where the licensing of agents in commodities by the Lord Mayor of London began during the reign of Edward I. The formality was an oath to be of good behaviour. Statutory licensing of securities brokers and stock-jobbers commenced in 1697 with the passage of an Act to limit the number of brokers and to prohibit undesirable practices. The South Sea bubble which collapsed in 1720 highlighted investment risks. In 1734, Bernard's Act was passed to outlaw options trading and short selling. The Prevention of Fraud (Investment) Act 1939, updated in 1958, provided for the licensing of dealers and set penalties for fraud. This Act was replaced by the Financial Services Act 1986.[75]

In Australia, until the enactment of the *Securities Industry Act 1970* (NSW), there was no substantial licensing legislation for the securities markets. Part IV of this Act provided that dealers and investment advisers had to be licensed. The strategy of legislators in framing that Act was to regulate by means of licensing all "intermediaries" engaged in the securities industry.[76] Licensing in relation to the futures industry was introduced for the first time, through the Futures Industry Code. Until then, the only regulation to which futures brokers were subject were the membership rules of the Sydney Futures Exchange.[77] The licensing of futures advisers[78] and futures brokers[79] are now covered by the Corporations Law.

1.4 Defining the parameters of the thesis and questions investigated

There is a wide range of issues concerning the regulation of financial derivatives, all of which are relevant, but a discussion of them all, except in so far as they are necessary to provide background information or the appropriate context, is beyond the scope of this thesis. A major exclusion is exchange traded derivatives, as these products are well regulated. Also excluded are a host of other issues, including those concerning taxation, electronic transmission and cross border.

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[75] Wood, PR, *International Loans, Bonds and Securities Regulations,* Sweet and Maxwell Limited, London, 1995, 260.
[76] Baxt, R, et al., note 53, 143.
[77] Currie, J, note 45, 183.
[78] Section 1143, Corporations Law.
[79] Section 1142, Corporations Law.

The central question being evaluated in this thesis is whether the regulatory system has the capacity to protect investors who trade in the OTC derivatives markets. Investor protection has been made the focus of this work in view of the various worrisome risks associated with derivatives trading. More specifically, the questions to be investigated are:

- Whether adequate regulatory measures exist to deal with the risks inherent in derivatives trading, including:
  - market risks
  - credit risks
  - legal risks

- Should all intermediaries be licensed so as to ensure proper oversight of their activities by a regulatory agency?

- Does the regulatory regime adequately address unfair practices and other misconduct?

- Should derivatives users be required to observe capital adequacy and other prudential requirements?

- Whether OTC derivatives traders are provided with adequate investor protection under the Corporations Law.

The above questions are intended to bring into focus the appropriateness of the existing regulatory regime. They assist in identifying gaps in the regulatory framework and thereby establish areas which are appropriate for law reform. As such, they form an integral part of the evaluation process of this thesis.

1.5 The thesis

This thesis identifies gaps and deficiencies in the Corporations Law regime[80] in relation to investor protection for participants trading in the OTC derivatives market and examines the extent which criminal and consumer legislation is capable of filling those gaps. It also identifies the gaps in the supervisory structure and argues that because of the complexity of the issues surrounding derivatives regulation and the ever changing nature of derivatives, adopting a minimalist approach to regulation would help to eliminate unnecessary regulation and consequently reduce costs.

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[80] This refers to the regime in Chapters 7 and 8 as at December 1997 which regulates securities and futures contracts.

The evaluation of the current regulatory framework is made through a multidisciplinary model which is discussed in the next Chapter.

CHAPTER 2

METHODOLOGY

2.1 Introduction

This thesis is concerned with an examination and evaluation of the regulatory regime governing over-the-counter (OTC) derivatives in Australia from the perspective of investor protection. More specifically, the thesis is focused on an identification of lacunae within the Corporations Law and an examination of the wider regulatory framework to determine the extent to which the general law and regulatory arrangements aid the Corporations Law in filling the gaps. Research methodological literature reveals a number of possible approaches for evaluating derivatives regulation, with economic and public policy techniques being the most popular.

The purpose of this Chapter is to describe and justify the methodologies used in this thesis. It argues that, in relation to a review of the regulatory structure of the Australian OTC derivatives market, a multi-disciplinary approach - based on traditional legal doctrines and combined with other disciplines, including comparative research methods, economic theories and public interest principles - is the most appropriate.

Such an approach has the advantage of making available a wide choice of research techniques for the study. It allows a suitable method to be applied to a specific area of the analysis where such a research technique is the most relevant. Each research strategy has its limitations and no single strategy is adequate for the analysis undertaken in this thesis. It is only by adopting a multi-disciplinary approach that the constraints of individual disciplines are overcome.

Before setting forth the methodology, it is appropriate to place the present study in the context of earlier research on the subject. Recent concern has been on OTC derivatives and, in consequence, research over the last few years has been centred on that topic. There is a plethora of reports, submissions, books and articles concerning OTC derivatives. Regulators and governmental agencies have initiated much of the research material generated in Australia. Major Australian reports, submissions and papers include the following:

Australian Securities Commission

- Policy Statement 70 (1993),
- Discussion Paper: Derivatives Traded On Over-The-Counter Markets (1993);[1]
- Draft Report On Over-The-Counter Derivatives Markets (1993),[2]
- Report On Over-The-Counter Derivatives Markets (1994),[3]

Companies and Securities Advisory Committee

- Law of Derivatives: An International Comparison (1995);
- Regulation of the OTC Derivatives Market (1995);
- Regulation of On -Exchange Derivatives Market, Draft Report (1996);
- Regulation of On -Exchange and OTC Derivatives Markets: Submission to the Financial System Inquiry (unpublished) (1996);
- Regulation of On-exchange and OTC Derivatives Markets, Final Report, (1997);

Companies & Securities Advisory Committee, (Netting Sub-Committee)

- Netting in Financial Markets Transactions, Background Paper (1996);
- Netting in Financial Markets Transactions, Draft Report (1996);
- Netting in Financial Markets Transactions, Final Report, (1997).

Insurance and Superannuation Commission

- Discussion paper: Derivatives for Superannuation (1995),
- Discussion paper: Derivatives for Life Insurance (1995); and
- Discussion paper: Derivatives for General Insurance (1995).

Wallis Inquiry

- Financial System Inquiry Discussion Paper (1996)
- Financial System Inquiry Final Report (1997).

1.Australian Securities Commission, 'Discussion Paper: Derivatives Traded On Over-The-Counter Markets', 1993 (ASC Discussion Paper).
2.Australian Securities Commission, *Draft Report On Over-The-Counter Derivatives Markets*, 1993 (ASC Draft Report).
3.Australian Securities Conunission, *Report On Over-The-Counter Derivatives Markets*, 1994 (ASC Final Report).

Treasurer's response to Wallis Report

- 'Reform of the Australian Financial System', a Statement by the Treasurer delivered at the House of Representatives, 2 September 1997; and
- 'Reform of the Australian Financial System: Details of Measures', additional document tabled in association with the Statement by the Treasurer delivered at the House of Representatives, 2 September 1997.

Others

- Parliamentary Joint Committee on Corporations and Securities: Report On Derivatives, (1995).[4]
- Mallesons, Stephen Jaques: 'Enforceability Survey - Australia', in the Group of Thirty, Global Derivatives Study Group, *Derivatives: Practices and Principles - Appendix II: Legal Enforceability: Survey of Nine Jurisdictions* (1993).

While most of these works discuss investor protection, not one provides a systematic examination of Chapters 7 and 8 of the Corporations Law to map out the reach of these regimes in respect of OTC derivatives. Such an examination is critical for it is only by defining the parameters of Chapters 7 and 8 that the lacunae in the Corporations Law regimes can be identified. The inadequacy of the provisions to protect investors would not be so critical if other laws exist within the legal system which could act as an effective substitute. So far, however, there has been no significant work done on whether the legal and regulatory system in Australia is capable of bridging the gaps in the Corporations Law.

This thesis addresses those issues, and in so doing, advances knowledge in several ways. First, it shows how OTC derivatives fit into the existing regulatory framework. Second, it provides a basis upon which a realistic assessment can be made as to whether the existing system is adequate to protect investors. Third, in carrying out a systematic examination of Chapters 7 and 8 of the Corporations Law, it builds on the work of recent research on the subject and provides a more comprehensive identification of regulatory gaps than undertaken to date.

2.2 Outline of the research approach and collection of data

For this present work, traditional legal research methods have been used to collect, analyse and synthesise both primary and secondary sources of material and literature. The term 'legal research' is used here to mean the "practice of finding and organising

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4. Parliamentary Joint Committee on Corporations and Securities, 'Report On Derivatives', Senate Printing Unit, Parliament House, Canberra, 1995.

the material which scholars use to development their particular arguments."[5] Primary material used includes statutes, case reports, as well as reports, policy statements and papers of regulatory agencies and Commissions initiated by the government. In the collection of secondary literature such as journals, articles, text books, loose-leaf services, speeches and papers, internet and other electronic technologies[6] have been used to supplement hard copies of material. The literature surveyed included those originating from several countries including Australia, United States, Malaysia, Singapore and England.

2.2.1 Analysis of gaps in the Corporations Law

The evaluation of the regulatory structure was carried out in three discrete parts. The first part of the exercise, undertaken in Chapter 5 of this thesis, involved a comprehensive analysis of the Corporations Law regime and focused on the gaps in the legislative framework in Chapters 7 and 8 of the Corporations Law. This was done by identifying the classes of OTC derivatives which are unregulated by this regime. The strategy was to divide OTC derivatives contracts into two groups: those that were governed by the Corporations Law but traded OTC and those OTC contracts that were not regulated by the Corporations Law. By identifying OTC contracts which were regulated, it was possible to pinpoint the classes of OTC derivatives contracts which were unregulated by the Corporations Law and were therefore within a regulatory gap.

The key to an identification of unregulated OTC derivatives contracts lies in the definitions of "securities" and "futures contracts" as any derivatives contract which does not fall within the definition of one of these two terms is automatically unregulated by the Corporations Law. The method adopted, therefore, was to look at the definitions of these terms in detail.

2.2.2 Gaps unfilled by the general laws

The second part (Chapter 6 of this thesis) was aimed at examining the extent to which the general law[7] would be capable of providing protection to investors in respect of transactions which are not regulated by the Corporations Law. This required an identification of whether any provision within the general law has the potential to

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[5] Corbett, A, 'Critical Theorising And Corporate Law', *Canberra Law Review*, Vol 3 No 1 1996, 104.
[6] I am deeply indebted to Professor Eugene Clark who recommended the use of electronic medium, and in particular the use of Lexis-Nexis which opens up a rich source of research material. See also Clark, E, 'Comparative Research in Corporate Law', *Canberra Law Review*, Vol 3 No 1 1996, 74-79; Dayal, S, *LDL Online: Laying Down the Law*, Butterworths, Sydney, 1996.
[7] The general law refers more specifically to criminal and consumer laws and excludes private remedies such as those available for breach of fiduciary duties or negligence.

protect investors trading in financial derivatives. Consumer and criminal laws for example, may be singled out as having the potential to fill the gaps left open by the Corporations Law. These laws have been identified because, although they are not specifically directed at derivatives market participants, they offer general protection against white collar crime and other unethical conduct.

The primary sources of consumer legislation in Australia are the *Trade Practices Act 1974* (Cth) ("TPA") and the Fair Trading Act ("FTA") of individual States.[8] As the TPA largely mirrors the FTAs, it was necessary to examine only the TPA mainly because there had been a greater number of reported cases concerning the TPA than the FTAs. Likewise, in view of the similarity of the Crimes Acts among the majority of the States and Territories and the *Crimes Act 1900* (NSW) ("Crimes Act"), only the Crimes Act was selected for examination. The selection of New South Wales is made on the basis that it is one of the most significant of the Australian States in terms of corporate misconduct.[9]

Having identified the relevant enactments, the next step involved an identification of an area which is common to the Corporations Law, the TPA and Crimes Act and which affords investor protection. As the common ground for these enactments is in the area of offences against property, the analysis focused on common malpractices in the securities and futures markets. The analysis was carried out in several steps. Selected offence provisions in the Corporations Law, which are drawn from Divisions 1 & 2 of Part 8.7 and Parts 7.11 and Division 6 of 7.12 of the Corporations Law, were categorised into manipulative offences, fraudulent offences and offences which are exclusive to the securities and futures markets.

Next, the corresponding provisions in the TPA and the Crimes Act were measured against each of the selected offence provisions in Chapter 7 and Chapter 8 of the Corporations Law. A comparative methodology was employed as it is only through a comparison of the conduct provisions which are, in broad terms, similar in all three statutes - the Corporations Law, the TPA and the Crimes Act - that the extent of the protection which these statutes provide to investors in respect of transactions unregulated by the Corporations Law can be determined. A direct comparison was not possible because only in a very few offences was there a close resemblance

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[8] *Fair Trading Act 1987* (NSW), *Fair Trading Act 1989* (Qld), *Fair Trading Act 1987* (SA), *Fair Trading Act 1990* (Tasmania), *Fair Trading Act 1985* (Vic) and *Fair Trading Act 1987* (WA). Additionally some State enactments are relevant, including *Contracts Review Act 1980* (NSW).

[9] For the half year 1 July 1995 - 31 December 1995, the State of New South Wales accounted for 16 of the 39 criminal cases initiated by the Australian Securities Commission. Source: ASC Digest 1996, Update 217, 1996 Lit 11 & 51.

between the provisions of one statute and the provisions of another.[10] However, applying the approach advocated by Charles Montesquieu that one is to look at the spirit of the law and not the law itself,[11] an analysis was made possible by focusing on the type of conduct which is proscribed and comparing the gravamen of each selected offence provision in the Corporations Law with the gravamen of similar offence provisions in the TPA and the Crimes Act. By this process it was possible to identify which offence provision in the TPA and Crimes Act could deter fraud, manipulative conduct (including deceptive and misleading conduct) as well as conduct specific to the securities and futures markets such as insider trading and hawking.

The identification of regulatory gaps was facilitated by the construction of a table using the information drawn from the comparison and the critical analysis. The table was divided into three columns. In the first column, the selected offence provisions were tabulated. As most offence provisions in Chapter 7 are duplicated in Chapter 8, similar offences provisions in Chapters 7 and 8 were grouped together. Such a grouping was useful in that it highlighted the anomalies between the penalty regimes in Chapter 7 and Chapter 8 of the Corporations Law. An example of an anomaly revealed by this process is hawking, a conduct which is proscribed in Chapter 7 but not in Chapter 8. Additionally, the table highlighted scope for unconscionable market conduct such as insider trading and frontrunning in the OTC derivatives market where there is a complete failure by the law (as represented by the Corporations Law, the TPA and the Crimes Act) to protect investors from the risk of loss through manipulative market practices.

2.2.3 Analysis of gaps in the supervisory structure

Finally, the third part was aimed at locating the gaps in the regulatory net cast by the regulators of the OTC derivatives markets. This is done by defining the role and functions of the regulators as regards investor protection. The analysis focused on both the regulators and on those they regulate. By examining the overall regulatory arrangement, it was possible to identify the participants who are not subject to any form of supervision by the regulators. This analysis was conducted in Chapter 7 of this thesis.

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[10] This bears out Charles Montesquieu's views that it is difficult for the laws of one system to serve those of another: See Corcoran, S, 'Comparative Corporate Law: Research Methodology', *Canberra Law Review*, Vol 3 No 1 1996, 54.

[11] Montesquieu, C, *The Spirit of the Laws*, Cambridge University Press, Cambridge, 1748, trans Cohler, A, et al., 1989, referred to in Corcoran, S, note 10, 54.

2.3 Rationale for the method adopted

This section of the Chapter is not a discourse of the various research techniques or models that may be used nor does it canvass any of the theoretical debates and issues that surround those research techniques. The objective here is to set out the rationale for the methodological approach taken, which is to recognise that, given the complexity of derivatives, their rapid expansion and the dramatic changes in derivatives products and market techniques,[12] and the multi faceted nature of regulatory concerns, research methods drawn from a single discipline would not be equal to the task demanded by this study.

The discipline of economics offers important insights into derivatives regulation. The application of economics principles has allowed regulation of financial markets, including the OTC derivatives markets, to be analysed from an efficiency perspective. For example, the approach adopted in the recent Financial System Inquiry (Wallis Inquiry),[13] was clearly influenced by the discipline of economics in giving recognition to the fact that regulatory arrangements may have a financial effect on the cost of capital for business and also that standards which are out of step with international practice could impose unnecessary costs and impede international competitiveness.[14]

Economic models are based on two main concepts, namely scarcity (and the allocation of scarce resources) and rationality (that people are assumed to act in their own best interest).[15] The first of these concepts is useful in providing insights into the costs of obtaining regulation which would be relevant to all investors. First, all investors benefit if the costs are low since they are able to enjoy lower transaction costs. Second, investors could be adversely affected by the high costs resulting from excessive regulation which shifts valuable resources from the markets toward

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[12] ASC Final Report, note 3, paragraph 222.

[13] Financial System Inquiry, *Discussion Paper*, Australian Government Publishing Service, November 1996 (Wallis Discussion Paper).

[14] Wallis Discussion Paper, note 13, 123. A number of writers from the United States have also favoured an economic approach. These includes: Macey, JR, 'Derivative Instruments: Lessons for the Regulatory State', *The Journal of Corporation Law*, Fall, 1995, 69; Albrecht, WP, 'Regulation of Exchange-Traded and OTC Derivatives: The Need For a Comparative Institution Approach', *The Journal of Corporation Law*, Fall, 1995, 111; Overdahl, J & Schachter, B, 'Derivatives Regulation and Financial Management: Lessons From Gibson Greetings', *Financial Management*, Vol 24 No 1, Spring 1995, 68; Traxler, F & Unger, B, 'Governance, Economic Restructuring, and International Competitiveness', *Journal of Economic Issues*, Vol 28 No 1, March 1994, 1; Hu, H, 'Misunderstood Derivatives: The Causes of Informational Failure and the Promise of Regulatory Incrementalism', *Yale Law Journal*, Vol 102, No 6, 1457-1513, April 1993.

[15] McEwin, RI, 'Law and Economics as an Approach to Corporate Law Research', *Canberra Law Review*, Vol 3 No 1 1996, 40.

regulatory compliance.[16] In so doing, regulation restricts innovation and competitiveness, thus producing an end result which would be a disservice to investors. For this reason, the economists' yardstick of costs and efficiency has been referred to throughout this thesis. Beyond this, however, the cost concept has little to contribute on the subject matter of investor protection, which is this thesis' main concern.

As regards the second economic concept, that of rationality, it is submitted that an evaluation of the capacity of the regulatory framework to deliver adequate protection to derivatives participants necessitates that the issue be probed beyond the level of the rational actors. It requires, in effect, an evaluation of the adequacy of statutory protection afforded to retail investors among whose numbers are the irrational players.

It has been argued that in the United States, the securities markets are significantly affected by irrational investment behaviour.[17] As the Australian markets generally move in sympathy with the United States capital markets,[18] and as capital markets are global in nature, irrational investment behaviour also can be expected in Australia. Such irrational behaviour often have flow through effects to the derivatives markets to which they are closely connected. Retail investors may act irrationally for a variety of reasons such as unfamiliarity with derivatives, a tendency to gamble away their life's savings, herd mentality[19] or because they are afflicted by unequal bargaining power such as not having the means to seek expert advice. It is this irrational behaviour that the law should seek to afford protection from. Therefore, a model which is premised on rational behaviour would be inappropriate where, as in the case of this thesis, the focus is on the protection of investors, including those who exhibit idiosyncratic behaviour.[20]

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[16] Culp, CL, & Mackay, RJ, 'Regulating Derivatives: The current System and Proposed Changes', CATO Regulation, *The Review of Business & Government* (undated), http://www.cato.org/pubs/reguladon/regl7n4b.html

[17] Hazen, TL, 'Rational Investments, Speculation, or Gambling? Derivative Securities and Financial Futures and their Effect on the Underlying Capital Markets", 86 *Northwestern University Law Review*, 1992, 987.

[18] A good example is the stock market crash of October 1987. A more recent example is the steep fall in Wall Street on 15 August 1997, a Friday, with an almost corresponding fall in the Australian stock market on 18 August 1997, the next business day.

[19] This refers to investors acting to buy or sell in sympathy with the majority of other investors. The October 1987 stock market crash is an example of irrational behaviour. This behaviour is best explained by John Maynard Keynes who suggested that the long term investor came in for the most criticism because "it is in the essence of his behaviour that he should be eccentric, unconventional and rash in the eyes of average opinion... Worldly wisdom teaches that it is better for the reputation to fail conventionally than to succeed unconventionally." See Windfield, R & Curry, S, *Success in Investment*, John Murray (Publishers) Ltd, London, 1985, 14 and Hazen, TL, note 17, 987.

[20] McEwin, RI, note 15, 42.

Regulating OTC derivatives markets to protect investors is defensible under public interest theories because these theories hold that regulation may be used in situations where there are people, such as irrational investors, who are incapable of protecting or less able to protect themselves. They provide justification for overriding the individual's freedom of choice through the promulgation of State laws and regulation.[21] The motivation stems from a paternalistic concern for the "welfare, good, happiness, needs, interests or values"[22] of those regulated, which in the context of this thesis, are the investors. As has been argued in Chapter 9[23] of this thesis, retail investors are in a disadvantaged position and require government regulation to protect them. For that reason, public interest principles were used in the discussion in Chapter 7 of this thesis to support the contention that there is a need for prudential regulation to cover a wider section of derivatives participants than is presently covered.

Despite the justification, paternalistic regulation does suffer from shortcomings. One example of such shortcomings is that regulation is generally made on the basis of applying uniform controls on all players of the OTC market. A "one size fit" rule deprives the sophisticated players (who are well equipped to make their own decisions competently) of freedom of choice.[24] A second problem with the application of public interest principles is costs because, as pointed out above, regulation increases costs.

These problems are not however insurmountable or irreconcilable and both economic and public interest concepts are capable of co-existing harmoniously and of being incorporated into a regulatory model for the OTC derivatives market. For example, in relation to the issue of unnecessary regulation for sophisticated investors, the legislature has long recognised the need for business efficacy by providing a mechanism in the Corporations Law to exempt certain participants and markets from the rigorous requirements of the Law regime governing securities and futures contracts. As regards the issue of costs, the fact that regulation is costly or difficult to comply with should not be a ground for rejecting regulation[25] particularly as they are necessary for the protection of investors.

In a limited way, historical methodology is also relevant to the present study because it assists in providing a better understanding, at a contextual level,[26] of some issues

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[21] Ogus, A, *Regulation: Legal Form and Economic Theory*, Clarendon Press, Oxford, 1994, 51.
[22] Ogus, A, note 21, 51 citing Dworkin, G, 'Paternalism', in Wasserstrom (ed), *Morality and the Law*, 1971, 108.
[23] At paragraph 9.4 of this thesis.
[24] Ogus, A, note 21, 53.
[25] This appears to be the view the ASC as expressed in ASC Final Report, note 3, paragraph 125.
[26] McQueen, R, 'Corporate Law and Historical Methodology: A Critical Perspective', *Canberra Law Review*, Vol 3 No 1, 1996, 8.

In a limited way, historical methodology is also relevant to the present study because it assists in providing a better understanding, at a contextual level,[26] of some issues which are currently of concern. The OTC market and the "plain vanilla" instruments are not new financial instruments but have been in existence, in some cases, for centuries in England, other parts of Europe, Greece and Japan. The historical discussion in Chapter 1 of this thesis showed that these instruments were imported into Australia from other countries along with some model of regulation, such as the licensing of brokers.

Insights gleaned from the discussion of the historical development of futures industry regulation in Chapter 1 of this thesis assisted in illuminating issues about regulatory gaps. The historical account of the development of futures regulation showed that with the advent of financial derivatives, no specific regulatory framework was developed but that policy makers and regulators opted to "make do" with a regulatory framework which was intended for the securities and futures markets. The regimes in Chapters 7 and 8 of the Corporations Law were tailored for the securities and futures markets and because they were not designed for financial derivatives, gaps and other deficiencies arise. Historical methodology was again used in Chapter 5 of this thesis to explain the rationale for enacting paragraph 72(1)(e) of the Corporations Law under which regulation may be made to exempt certain persons and transactions from the operation of the Corporations Law.

While developments in the past[27] helped to explain the difficulties in the present regulatory structure, historical methodology offers limited scope in providing guidance for law reform, mainly because of changes in historical patterns. Recent financial history shows that the pace of innovation in the derivatives market is more rapid than ever before, and that developments have shown a marked deviation from traditional patterns where the life cycle of most products is of reasonable duration.[28] By contrast, a number of the new financial derivatives have a shorter life span, as they are continuously replaced by innovations. Another discernible change in pattern is the growth of OTC derivatives. Developments in derivatives products in the last few years have concentrated on OTC instruments.[29] The rapid expansion of the OTC derivatives markets, both in terms of volume and the number of products, has reversed

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[26] McQueen, R, 'Corporate Law and Historical Methodology: A Critical Perspective', *Canberra Law Review*, Vol 3 No 1, 1996, 8.

[27] See for example Petzel, TE, 'Derivatives: Market and Regulatory Dynamics', *The Journal of Corporation Law*, Fall, 1995, 95. Todd Petzel, an American writer, employed the historical approach effectively to identify the roots in traditional futures contracts and then use that to explain the regulatory issues confronting the United States.

[28] Macey, JR, note 14, 70.

[29] Macey, JR, note 14, 71.

the trend of having an increasing number of financial products being traded on the exchanges.[30] Added to the shift in historical pattern are the complexities of existing regulatory issues, some of which were discussed in Chapter 3 of this thesis. It is submitted that although historical methodology, to the extent that it puts into context the existing regulatory issues, has helped to inform this thesis, it does not shed much light on how the current problems are to be addressed because the past has no experience which parallels the problems of today.

Before turning to provide the justification for the use of legal research methods in chapters 5 and 6 of this thesis, comparative methods in Chapter 6 and critical theories in Chapter 7, brief mention must be made of sociology. Social science methods and theories have made an impact on research into corporate law issues, particularly in recent years. The work of Tomasic and Bottomley,[31] Grabosky and Braithwaite[32] and Fisse and Braithwaite[33] are examples of contributions to corporate law studies in the Australian environment.[34] Many of the social science methods focus on behaviour of the various actors being studied and is generally concerned with looking at law as it is practised. These methods have been employed in such research projects as the role and effect of bureaucratic structures in society and on individuals and the creation and enforcement of intra-organisational rules and the importance of organisational values.[35] Sociological approaches assist in highlighting the gaps that often exist between formal legal laws (as written in the statutes) and the practises of those laws.[36] However, it is not a suitable research technique for this thesis because many of the social science methods are concerned with behaviour of the courts, the enforcement agencies and compliance. The analysis in Chapters 5, 6 and 7 of this thesis is concerned with a scrutiny of the legal rules and doctrines,[37] and not with behaviour of the derivatives participant or regulators. Accordingly, social science methods were not applied.

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[30] Macey, JR, note 14, 70.
[31] Tomasic, R & Bottomley, S, *Directing the Top 500*, Allen & Unwin, Singapore, 1993.
[32] Grabosky, P & Braithwaite, J, *Of Manners Gentle: Enforcement Strategies of Australian* Business *Regulatory Agencies*, Oxford University Press, Melbourne, 1986 cited by Tomasic, R, 'Using Social Science Research Methods in the Study of Corporate Law', *Canberra Law Review*, Vol 3 No 1 1996, 26, f/n 23.
[33] Fisse, B & Braithwaite, J, *Corporations, Crime and Accountability*, Cambridge University Press, Melbourne, 1993 cited by Tomasic, R, note 32, 26 f/n 23.
[34] Tomasic, R, note 32, 25.
[35] Bottomley, S, 'Corporate Law Research and the Social Sciences: A Note of Encouragement', *Canberra Law Review*, Vol 3 No 1 1996, 34.
[36] Bottomley, S, note 35, 34.
[37] Tomasic, R, note 32, 24.

Instead, traditional legal research methods were used. In paragraph 2.1 of this Chapter, it was noted that central to the analysis of the statutory framework in Chapter 5 of this thesis is an identification of gaps in the investor protection regime in Chapters 7 and 8 of the Corporations Law. The choice of traditional legal research as the dominant paradigm for the evaluation was dictated by the nature of the analysis. The identification of regulatory gaps within the Corporations Law regime necessitated an examination of definitions of key terms in that Law. Chapters 7 and 8 apply to derivatives contracts which are within the strict legal definition of "securities" and "futures contracts" but not otherwise. This calls for the use and analysis of legal doctrines, case law and statutes. Likewise, legal research techniques were employed in the enquiry conducted in Chapter 6 of this thesis. This enquiry, which is directed at errant behaviour of market participants, required an examination and analysis of the penal provisions and sanctions which are used to deter unacceptable commercial conduct in the Corporations Law, the TPA and the Crimes Act. Legal methods aid in this process.

But purely traditional legal scholarship has its limitations. The use of legal research techniques enabled the task in Chapter 5 to be performed satisfactorily. However, legal research by itself was obviously inadequate in the analysis of the general laws in Chapter 6 of this thesis. Comparative law methods were also used.

Comparative law is defined as the study of the relationship of one legal system and its rules with another.[38] It is practical[39] and because it adopts a more juristic point of view and studies the rules or institutions of law in relation to each other,[40] comparative law is of assistance to traditional legal analysis. In the context of Chapter 6 of this thesis, comparative methodology was the natural and undoubted choice as a supplement to legal research methods. This is because a significant portion of the analysis - dealing with the issue of whether the TPA or the Crimes Act is capable of delivering similar investor protection equivalent to the sanctions regime of the Corporations Law - required a comparison of the provisions in the Corporations Law with corresponding provisions in the TPA and the Crimes Act. Comparative research method facilitated the examination of the proscriptive conduct regimes in these three enactments, primarily because the basic methodological principle of all comparative law is that of functionality,[41] and the area for comparison in all three statutes can be

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[38] Corcoran, S, note 10, 54.
[39] Corcoran, S, note 10, 55.
[40] Zweigert, K & Kotz, H, *An Introduction to Comparative Law, The Framework*, Volume I, North Holland Publishing Company, Amsterdam, 1977, 9.
[41] Zweigert, K & Kotz, H, note 40, 25.

reduced to a common denominator, which is the manner in which each of these laws protect investors from economic "misconduct" of others in the derivatives market.

For instance, in respect of sections 997 and 1259 of the Corporations Law, which prohibit a range of manipulative conduct in the securities and futures markets, comparative methodology was applied to compare the elements of the offences in sections 997 and 1259 of the Corporations Law against the elements of the offences in sections 45(2), 46, 50, 51AB and 52 TPA and also against the elements of the offence proscribed under section 178BA of the Crimes Act.

There is some degree of overlap between the provisions in the Corporations Law and the parallel provisions in the TPA and the Crimes Act. By the use of comparative methods, it was possible to determine the extent of the duplication by the TPA and/or the Crimes Act and consequently to determine if these laws provide protection to investors which are comparable to those in the Corporations Law. The comparative analysis has potential practical application. It has assisted in identifying those "conduct" provisions in the TPA and Crimes Act which are capable of being used against offenders operating in the OTC derivatives markets but in respect of whom the Australian Securities Commission is powerless to act because the transaction is outside the Corporations Law.

Another ancillary discipline which was incorporated into the methodological design was critical theory. Critical theorising performed a useful function in this thesis and more particularly, in Chapters 7 and 8. An evaluation of the Wallis Committee's recommendations as contained in the *Financial Sytem Inquiry, Final Report* on investor protection and CASAC's recommendations in its final report on *Regulation of On-exchange and OTC Derivatives Markets* would not have been complete without a critical anaysis of the relevant recommendations. The method allowed the use of all available information[42] which is collected through traditional research methods,[43] without having to adopt the theoretical perspectives found in the literature from which the information was drawn.[44]

The approach adopted in this work is a departure from the methodology used in traditional legal theses which, until a decade or so ago, were usually doctrinal in nature and there were few which ventured beyond the bounds of legal research techniques. It

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[42] Centre for Critical Thinking, 'Generating or Assessing Solutions', 1996; http://www.sonoma.edu/cthink/k12class/strat/19.nclk

[43] Corbett, A, note 5, 107.

[44] Corbett, A, note 5, 106.

is submitted that there is a need for more research outside the conventional legal methods. The use of other disciplines as a supplement to legal research provides a better understanding of the subject matter under study. Some studies, like the regulation of derivatives, would benefit from being informed by theoretical contributions of other disciplines. Derivatives are not just about contract law. They are subject to disciplinary influences of economics, history, public policy and others. The conclusion to which this brief review of different disciplines leads is that a model which applies legal doctrines and treats traditional legal research methods of analysis as central but not to the exclusion of other disciplines provides a holistic understanding of the gaps in the regulatory structures.

2.4 Limitations

It is acknowledged that the research strategy used in this study placed some significant limitations on the study. First, the identification of regulatory gaps, the subject matter of this thesis, centres on the gaps in the control of undesirable conduct in the market place. The narrowness of its focus constitutes a major shortcoming in the methodology adopted. There are many facets to investor protection and regulating conduct is but one of the several forms. Others are equally important and these include mandatory disclosure requirements (which is another regulatory tool to ensure a level playing field for investors) and adoption of risk management systems (to minimise trading risks). All these forms are worthy of examination but in view of the constraints on time and resources, were not reviewed in detail in this thesis.

Second, the comparison of the offence provisions of the Corporations Law and consumer and criminal legislation is not comprehensive. Among a range of consumer protection enactments, only the TPA was examined and similarly among the Crimes Acts of the various States and Territories, only the Crimes Act 1900 (NSW) was selected. Again the constraints on time require that a balance be struck between what is ideal on the one hand and what is practical and realistic on the other. The fact that the regulation of financial derivatives is on the agenda of policy makers, legislators and regulators has made the time factor more significant. Given that the provisions under examination in the TPA are virtually identical to the Fair Trading Acts of the various States and Territories and that there is marked similarity among the States' Crimes Acts, it is submitted that this does not constitute a significant limitation.

Third, private law remedies, which are available under contract or tort law, have not been analysed or discussed in this thesis. These remedies are relevant as they may have the potential to act as effective substitutes to the sanctions regime in the Corporations Law. An analysis of private law remedies and the extent to which they

compensate for the gaps in the Corporations Law would be beyond the scope of this work. Such an analysis could well be the subject matter of another thesis.

Fourth, no attempt has been made to evaluate the appropriateness of the sanctions regime to determine if it contains the right regulatory mix of criminal and civil remedies. This is an issue which requires further empirical study.

Fifth, the approach taken is based on traditional legal methods but combine with insights from other disciplines including comparative methods, critical theories, economics, public policy, and historical methods. The exclusion of other disciplines such as anthropology, politics and sociology could give rise to the spectre of a flawed methodology. However, much thought has been given to the selection of methodologies. In a thesis of this size, it had not been possible to accommodate other methodologies, although they are also relevant to this study.

Lastly, in adopting a model based primarily on legal concepts but incorporating aspects of comparative, critical and analytical methodologies, the approach may be seen to be flawed as the insights from multiple disciplines are arguably superficial. Despite this perceived disadvantage, it is submitted that a multi-disciplinary approach provided a better model as it was possible to make use of insights from selected disciplines to inform the subject of the study. The issues concerning investor protection transcend individual disciplines and a multi-disciplinary model brings the relevant concepts, knowledge, and insights from various disciplines within the analysis.[45]

2.5 Conclusion

This Chapter has explained the reasons for the selection of the methods through which the regulatory system is to be examined for its capacity to protect OTC investors. In opting for a multi-disciplinary model, consideration has been given to the complex nature of derivatives, their rapid transformation into new products and the innovativeness of the derivatives market players in formulating new market techniques, all of which give rise to complex regulatory concerns.

Such complex regulatory issues cannot be meaningfully examined through the interrogation of a single discipline. As explained above, each individual discipline has its limitations. Economics, while making it possible for regulation of OTC derivatives markets to be analysed from an efficiency perspective, is of little assistance in

[45] Centre for Critical Thinking, 'Making Interdisciplinary Connections', 1996. (http://www.sonoma.edu/cthink/K12/k12class/strat/23.ncik).

identifying the gaps in the regulatory structure. Likewise, although traditional legal research methods are the most appropriate tools in analysing gaps in Chapters 7 and 8 of the Corporations Law, they are inadequate for the identification of gaps in the sanctions regime. For such an identification, comparative methodology needs to be employed. For these and other reasons discussed above, a multi-disciplinary approach is ideally suited to this study.

As the issues relating to investor protection cannot be discussed in a vacuum, the following Chapter provides an overview of financial derivatives which is necessary to set the thesis in context.

CHAPTER 3

OVERVIEW OF DERIVATIVES

3.1 Introduction

The objective of this chapter is to provide general background information on financial derivatives and to identify some of the risks encountered in trading in these instruments which give rise to regulatory concerns.

Notwithstanding those concerns, financial derivatives are now an essential part of the capital markets. Financial derivatives make it possible for investors to protect themselves against adverse market movements.[1] For instance, trading companies are exposed to market risks in three main areas which may affect their profitability. First, there is the risk of price changes in the commodity they buy or sell; second, if payment for the goods is to be in a foreign currency at a future date, there is the risk of the exchange rate going up and third, if the payment is to be made from proceeds of a loan granted on a floating rate, there is the risk of the interest rate going up. An adverse change in price, exchange rate or interest rate would affect the profitability of the company.

Financial derivatives can help to ensure that the trading company's operating profits are predicted with some degree of certainty. A company exporting wool in six months time can fix the price of that export now by entering into a forward contract to sell wool at a specified price to be delivered in six months time; a borrower in Japanese yen can swap the proceeds of its loan for Australian Dollars; and a borrower who has contracted to pay floating rate interest on its loan may swap that floating rate interest with a counterparty who is prepared to accept the floating rate interest in exchange for fixed rate interest. Thus, derivatives can be employed to protect the value of a company's assets.

The usefulness of these synthetic instruments is one of the main reasons for their rapid growth, particularly in the last decade. For instance, global exchange-traded instruments grew from US$583 billion in 1986[2] to US$16.6 trillion as at 31 March

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[1] Companies & Securities Advisory Committee, 'Regulation of On -exchange Derivatives Market, Draft Report', 1996 (CASAC on exchange DP 1996), 3.

[2] Australian Securities Commission, 'Report On Over-The-Counter Derivatives Markets', 1994, (ASC Final Report), 11 (Table 2) citing as its source, the Futures Industry Association (FIA), International Swap Dealers Association (ISDA); Bank of International Settlements calculations, which had been reproduced from Bank of International Settlements, *Recent Developments in International Bank Relations*, Basle, October 1992 (BIS, 1992).

1995[3] in notional principal amounts while OTC derivative instruments grew from an approximate US$500 billion[4] to US$40.7 trillion over the same period.[5] By the end of March 1995, the total volume of derivatives trade amounted to US$57.3 trillion in notional principal amounts.[6]

In part, the dramatic increase in the volume of trading is aided by the capacity of the capital markets to respond innovatively to the demands of end users.[7] The complexity of modern day commercial transactions, the rapid advancement in information technology,[8] coupled with the deregulation of financial markets in Australia[9] and overseas[10] have created a need for more innovative products to meet the challenges of the world of commerce. This demand for better ways to manage financial risk has given impetus to a proliferation of new "exotic" derivative instruments and strategies, such as amortising swaps,[11] rollercoaster swaps,[12] basket options,[13] rainbow options,[14] butterfly spreads,[15] swaptions[16] and quanto options.[17]

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[3] Banks for International Settlements, 'Central Bank Survey of Derivatives Market Activity', Basle, 18 December 1995 (BIS 1995), 4.
[4] ASC Final Report, note 2, 11 (Table 2).
[5] BIS 1995, note 3, 6.
[6] BIS 1995, note 3, 1 & 2.
[7] 'Other Developments', *Federal Securities Law Reports*, 13 July 1994, 4.
[8] Smith, R C & Walter, I, *Global Financial Services: Strategies For Building Competitive Strengths In International Commercial and Investment Banking*, Harper Business, New York, 1990, 74, 446.
[9] Deregulation was responsible for the floating of the Australian dollar in December 1983 which caused increase in intra-day volatility (the average change in price within a day) and short term volatility (the average week to week or month to month change in price) - See Daugaard, D, & Valentino, T, *Financial Risk Management: A Practical Approach To Derivatives*, Harper Educational Publishers, 1995, 3.
[10] See Smith, R C & Walter, I, note 8, 67.
[11] Winstone, D, *Financial Derivatives: Hedging with Futures, Forwards, Options and Swaps*, Chapman & Hall, London, 1995, 267 explains that the notional principal amount of such a swap reduces during the life of the swap.
[12] Winstone, D, note 11, 267 notes that the notional principal amount of this swap is allowed to either increase or decrease in line with the needs of the swap counterparty.
[13] This is an option on a basket of securities, with the payout at maturity being based on a weighted average of the prices of the component securities rather than the price of one security - see Galitz, L, *Financial Engineering: Tools and Techniques to Manage Financial Risk*, Pitman Publishing, London, 1995, 448.
[14] Such an option provides the buyer with a payoff based on the maximum (minimum) price achieved by several underlyings (for example the All Ords Index, the FTSE100, Dow Jones, Nikkei) allowing the call buyer to receive a payoff based on whichever index shows the greatest appreciation - see Galitz, L, note 13, 448.
[15] This is a spread position in options involving buying and selling options with three different strike prices for three consecutive delivery months in the same future - see Galitz, L, note 13, 270; Winstone, D, note 11, 283.
[16] This is an option to enter into an interest rate swap on some future date - see Galitz, L, note 13, 288.
[17] The payoff in this option depends on one underlying price, but the size and value of the exposure depends on another. Such an option may be quoted in one currency upon an underlying asset denominated in another. For a better understanding of Quanto options, see Galitz, L, note 13, 300-301.

As a consequence of the growth in derivative transactions and the increasing complexity of derivatives instruments, concerns arise as to the risks which derivatives may pose to the financial system, investors and even taxpayers.[18] It is feared that the sudden failure of a large derivatives dealer or user could cause liquidity problems in the capital markets which in turn could expose other derivatives players, including banks and superannuation funds and perhaps even the entire financial system[19] to systemic risk.

To put in context the current issues on derivatives regulations, this Chapter seeks to provide an overview of financial derivatives, highlighting significant aspects of these instruments which have a bearing on the issues raised in relation to the current regulatory framework.

3.2 What are derivatives?

In the context of capital markets, the term "derivatives" is a generic name used to describe certain financial contracts which are principally employed to manage financial risk.[20] Sometimes referred to as financial engineering tools, they are generally made up of four basic categories of instruments - options,[21] swaps, forwards and futures. Whilst these "plain vanilla" instruments have been used for decades and are familiar to investors and intermediaries, it is the new generation of derivatives that causes most concern. These newer forms include combinations of one or more of the basic derivatives.

The Group of Thirty, in its study on over-the-counter derivatives entitled 'Derivatives: Practices and Principles', explains that:

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[18] 'Other Developments - Global Marketplace', *Federal Securities Law Reports*, 13 July 1994, 5.

[19] See United States House of Representatives, *Review of Reports by the US General Accounting Office and the Commodity Futures Trading Commission on Derivative Products*, a hearing before the Subcommittee on Environment, Credit and Rural Development of the Committee on Agriculture at the One Hundred and Third Congress, Second Session, June 14, 1994, US Government Printing Office, Washington, Serial No 103-75, 8.

[20] Derivatives are also used for arbitrage and speculation for profit although hedging and risk management purposes are the most common.

[21] A popular form of options which is fast gaining in importance in the equity markets is the warrant, which essentially is a long dated call or put option - see Tribe, D, 'Warrants replace futures as flavour of the month on ASX', *The Sydney Morning Herald*, 28 February 1996; Kavanagh, J, 'Warrants offer arresting option', *The Weekend Australian*, 30-31 March 1996, 13; Wasiliev, J, 'Warrants a Punt', the *Financial Review*, 2 November 1995, 8.

> "(i)n the most general terms, a derivatives transaction is a bilateral contract or payments exchange agreement whose value derives, as its name implies, from the value of an underlying reference rate, or index. Today, derivatives transactions cover a broad range of 'underlyings' - interest rates, exchange rates, commodities, equities and other indices."[22]

This is broadly similar to the definition adopted by the Australian Securities Commission ("ASC") in its 'Report On Over-The-Counter Derivatives Markets' in which a derivatives instrument is defined as belonging to "that class of financial contracts whose value depends on the value of one or more underlying assets or indexes of asset values."[23] A derivatives transaction has also been defined as a financial contract whose value is designed to track the return on stocks, bonds, currencies or some other benchmark.[24]

For the purposes of this thesis, the definition formulated by the Group of Thirty will be used and that the term "underlying" will be adopted to mean the underlying reference interest rate, exchange rate, commodity, equity or other index or any other underlying asset.

3.3 Classification of derivatives

Derivatives fall into two basic groups, namely, options and forwards.[25] The term "forwards" in this context encompasses swaps and futures,[26] although in practice, they are often divided into the four basic groups noted above, namely: futures, forwards, options and swaps. The more complex forms of derivatives are constructed from options and forwards. Therefore, all derivatives are either forward based products or option based products or hybrids, that is, products which are a combination of both. The diagram appearing in the following page explains this classification.

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[22] Group of Thirty, Global Derivatives Study Group, 'Derivatives: Practices and Principles', Washington, 1993, 3.

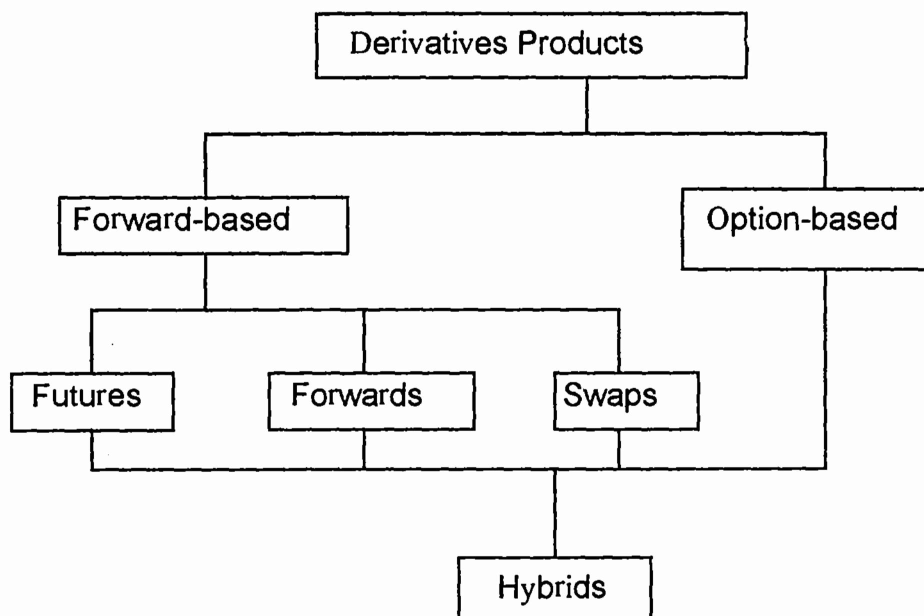
[23] This definition appears to have originated from the Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation and Office of Comptroller of the Currency (1993) *Derivative Product Activities of Commercial Banks: Joint Study Conducted in Response to Questions Posed by Senator Riegle on Derivative Products*, 27 January 1993 - see the Australian Securities Commission, 'Report On Over-The-Counter Derivatives Markets' May, 1994, 7, footnote 3.

[24] McDougall, B, 'For the Younger Banker: Derivatives De-mystified', *The Australian Banker*, April 1994, 85.

[25] Group of Thirty, note 22, 29; Companies & Securities Advisory Committee, 'Regulation of the OTC Derivatives Market, Discussion Paper', 1995 (CASAC OTC DP 1995), 3.

[26] Group of Thirty, note 22, 29.

Figure 1



Categorising derivatives into options and forwards in accordance with their characteristics or functionality is one way of classifying these instruments.

Frequently, however, derivatives are classified according to whether they are listed on exchanges (exchange traded) or are contracted privately or over-the-counter (OTC). Exchange traded derivatives are mainly futures contracts or derivatives over securities which are traded on the Australian Stock Exchange, Derivatives (ASXD) or the Sydney Futures Exchange. Such contracts are standardised contracts. The OTC derivatives, on the other hand, are customised contracts, tailored to suit the specific needs of the parties to the transaction. There are other differences. OTC derivatives are intermediated by banks and other financial institutions and are negotiated between two counter parties whereas exchange traded derivatives are contracted openly through organised exchanges, with the clearing house as a counterparty to every contract. OTC contracts, therefore, cannot be traded in the way that on-exchange contracts can be bought or sold.[27] The feature which most distinguishes an exchange traded contract from an OTC contract is its fungibility as one contract from the same class with the same maturity can be a perfect substitute for another.

From the regulatory perspective, this classification is important as OTC derivatives instruments are largely unregulated unlike the exchange traded variety which are

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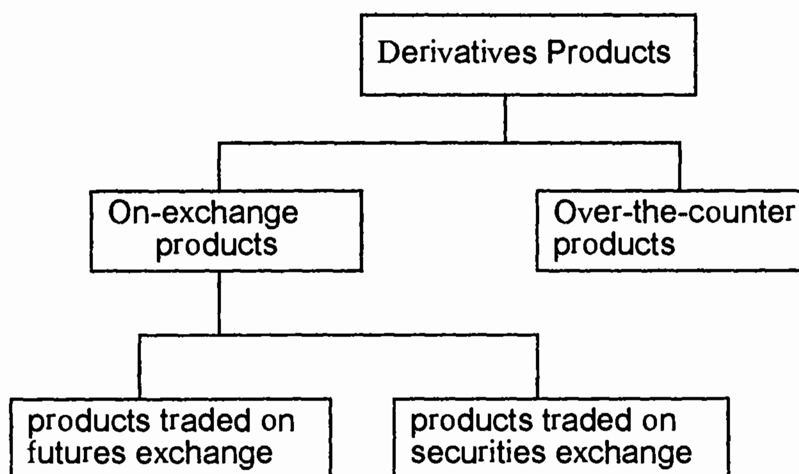
[27] Australian Securities Commission, 'Policy Statement 70: Exempt Futures Markets', 1993 (Policy Statement 70).

heavily regulated by the Corporations Law, the business rules of the exchanges and the clearing houses. The figure below shows this form of classification.

Figure 2



3.4 Uses of derivatives

Derivatives serve different purposes for different users. They are, however, associated mainly with hedging and in this respect they serve an important function in commerce. They provide opportunities for trading entities[28] to protect themselves against adverse changes in areas which could affect their profitability, such as interest rates, currency exchange rates and commodity prices. How this can be done has been illustrated in paragraph 3.1 above. In this context, derivatives are used to manage financial risk.

Derivatives have become so well recognised as tools for the proper financial management and control of risks that they can no longer be ignored.[29] Company directors who exclude the use of derivatives do so at their peril. In the United States, directors have been held liable to their company for negligence for failing to consider using derivatives as a means of hedging.[30]

Other than risk management, another key use of derivatives is arbitrage. They are frequently used by arbitragers whose aim is to exploit the inefficiencies in the markets

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[28] Derivatives are also widely used by governments and statutory corporations to manage risks. The New South Wales Treasury Corporation was reported to have made a savings of $2 billion over ten years by hedging: see Bull, K, 'Does Government Have a Future in Derivatives?' *ABLR*, Vol 25, August 1997, 246, 249.

[29] McDougall, B, note 24, 86.

[30] *Brane* v *Roth*, a 1993 case in the US where an Indiana court held the directors of an Indiana grain handling co-operative liable for the loss of US$424,000 which could have been avoided if grain futures on the Chicago Board of Trade were used. See McDougall, B, note 24, 86; see also Crawford, G & Sen, B, *Derivatives for Decision Makers*, John Wiley & Sons, Inc., New York, 1996, 171-72.

to make a gain.[31] Thus, an arbitrage may be explained as a technique used by a trader to make a profit trading in the same commodity (eg Australian currency) in two or more markets by taking advantage of the difference in prices in those markets. Essentially, an arbitrage is effected when a trader buys in one market at a lower price and then sells it in another market at a higher price. If both transactions can be carried out almost simultaneously, there is no risk to the trader as, having sold the commodity that was bought, the profit is locked in.

Whilst the use of derivatives for hedging and arbitrage seldom gives rise to concerns, there is, however, a more worrisome use of derivatives. This is speculation. The colossal losses - to the magnitude of hundreds of millions of US Dollars - suffered in recent years by Proctor and Gamble, Metallgesellschaft and Baring Pic are as a consequence of the speculative activities of these corporations or their employees.

Derivatives, especially options, are susceptible to speculation as they require very little capital outlay but offer the prospects of high returns or high losses. Speculators are able to take advantage of leverage by buying a derivatives instrument which generally costs only a fraction of the actual price of the underlying asset. As the underlying increases in price, so will its derivatives. The lower cost of the derivatives enables the speculator to buy rights, such as an option, over a larger number of units of the underlying than would have been possible had the speculator bought the actual underlying itself. Thus, if the unit price of the underlying increases, the speculator's profit will rise correspondingly in accordance with the number of units over which it has rights to purchase. The danger in taking a position in derivatives is that losses are magnified and are much larger in percentage terms than speculation on the underlying commodity. The opportunities provided for leverage is, to speculators, one of the most attractive attributes of derivatives.

Although speculation is generally considered as an undesirable activity, it has been argued that speculators serve a purpose beneficial to the market. Speculators add depth and liquidity to the markets by taking the opposite side of transactions when most market participants are interested only in one side.[32] By so doing, they reduce the volatility of the markets.

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[31] Daugaard, D, & Valentino, T, note 9, 5.

[32] Daugaard, D, & Valentino, T, note 9, 5.; CASAC OTC DP 1995, note 25, 4; *Sydney Futures Exchange Limited v Australian Stock Exchange Limited and Australian Securities Commission (Intervener)* Fed No 86/95 (1995) 3 ACLC 369 (SFE *v* ASX 1995) per Lockhart J.

Outside of these three main uses, derivatives may also be used to achieve transactional efficiency, expand a financial institution's range of products, adjust exposure to risks and reduce volatility.[33] Transactional efficiency may be achieved, for instance, by buying a derivative over an underlying rather than the underlying asset itself. Such a derivative transaction may be entered into more quickly, at lower administrative charges and transactional costs since the initial outlay is lower.[34]

These instruments have also made it possible for banks and superannuation fund managers to expand their range of products for sale to customers. The fund managers' "capital protected funds" and the banks' "capped rate mortgage" are examples of derivatives-related products.[35]

Additionally, derivatives are used by fund managers and investors in managing portfolio of investments. For example, an anticipated short term market downturn in equities may make it desirable for a fund manager to switch partially out of equities to debt exposure. By merely selling stock index futures and buying long term interest rate futures, the investment portfolio could be altered without incurring the expense or work involved in selling the underlying.[36]

It is expected that with constant changes and innovation, derivatives activities will continue to accelerate and expand to encompass a wider net of end users, including those in the retail sector.

3.4.1 Reasons for growth of derivatives

A number of economic arguments[37] have been advanced to explain the rapid pace of financial innovation and growth in the volume of transactions. First, derivatives are risk management tools which enable one party to a transaction to shift the risks associated with that transaction to the counterparty who either has a comparative advantage in assuming that risk or who is willing to bear that risk for a fee.[38] This enables an investor to manage its exposure to future uncertainty in relation to the performance of an underlying asset by purchasing, through the use of a derivative

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[33] CASAC OTC DP 1995, note 25, 4. See Appendix 2 (Glossary) on volatility.
[34] CASAC OTC DP 1995, note 25, 4.
[35] Kavanagh, J, 'A Look at the "OTC" Market', *Business Review Weekly*, 30 April, 1993, 33.
[36] Cresswell, PJ (ed.) et al, *Encyclopaedia of Banking Law*, Volume 2, Butterworths, London, 1982, F3437.6.
[37] Macey, JR, 'Derivative Instruments: Lessons for the Regulatory State', *The Journal of Corporation Law*, Fall, 1995, 69 at 71-81.
[38] The use of a derivative instrument does not eliminate, nor does it increase or decrease, the risk of holding the underlying asset. All that a derivatives instrument does is to transform future uncertainty in relation to that underlying into a risk to be assumed by the counterparty. See Macey, JR; note 37, 72.

instrument, certainty about future performance of that underlying. The use of derivatives for this purpose assists business certainty and growth[39] and encourages the development of new solutions to manage a variety of risks.

Second, in addition to achieving transactional efficiency, derivatives instruments help to lower transaction and agency costs by minimising the effects of information asymmetry. For instance, banks often act as intermediaries and earn a fee in packaging a derivative transaction by utilising their superior information about the borrowing needs and credit worthiness of the parties to the transaction while at the same time, each counter party derives a benefit by achieving a lower transaction cost.[40] The lower costs provide the financial incentives to use derivatives in substitution for the underlyings.

Third, the use of certain creative derivatives such as a zero coupon bond provides a tax advantage for the United States and Japanese investor. Until the tax law was changed, the US investor was able to amortise the implicit interest on a zero coupon bond on a straight line basis.[41] As for the Japanese investor, income earned on a zero coupon bond is treated as a capital gain on which no tax is payable.[42] The tax arbitrage made possible by the use of those derivatives help to maximise wealth and this in turn promotes greater use and consequently growth in volume of transactions.

Fourth, it has been argued that the use of derivatives assists in revenue maximisation by means of speculating in the derivatives markets.[43] How this may be achieved has been discussed above.

This section discussed some of the main uses of derivatives, namely hedging, arbitrage and wealth maximisation or speculation, and explained the reasons for their rapid growth. It highlights the economic importance of these financial products and their practicality and justifies their continued existence. In the following section, the more basic forms of derivatives are examined.

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[39] See also CASAC on -exchange DP 1996, note 1, 3.
[40] Macey, JR, note 37, 74.
[41] Macey, JR, note 37, 76 citing Boot, AA, et al., 'The Theory of Security Design 11', Tinbergen Institute Discussion Paper No. TI 94-19, 1994.
[42] Macey, note 37, 76.
[43] Macey, note 37, 78.

3.5 Basic derivatives

As seen in paragraph 3.3, financial derivatives are often divided into four main groups - futures, forwards, options and swaps: These groups are the 'basic' or 'plain vanilla' products.

3.5.1 Futures[44]

In common parlance, a futures contract is a standardised contract,[45] traded on an organised exchange,[46] which obliges the parties to the futures contract either to buy or to sell an asset (commodity, financial instrument or others) at a specified price on a fixed future date. At the time of registration of the contract between the buyer and the seller (called a "market contract"), two futures contracts (called "open contracts") are deemed to be constituted - one between the clearing house and the buyer and the second between the clearing house and the seller.[47] By being a counterparty, the clearing house of the relevant exchange is effectively "guaranteeing" payment in case one of them (buyer or seller) defaults. The "buyer" and "seller" are defined in Clearing By-Law 1.1 to include floor members who traded the market contract. In practice, the "buyer" and "seller" are floor members and not the clients who gave the buy or sell orders.

Such a futures contract traded on the exchanges is fungible in that the product covered by the contract is of a standard grade and quality. Even the delivery date is identical to the delivery date of other futures contracts in the same class. The buyer and seller are required to put up a margin, equal to a certain percentage of the contract's underlying value, which is marked to market[48] daily. Futures contracts may be categorised as commodity futures or financial futures, the former being used to manage commodity price risk while the latter being used to manage interest rate and currency risks[49].

All futures, because they are traded on the exchanges, are regulated by the Corporations Law and by the Business Rules of the relevant exchanges.

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[44] "Futures contract" as defined in section 72 of the Corporations Law, is not limited to exchange traded futures contracts but includes OTC futures (that is, forward contracts), so long as such OTC contracts are within the definition of section 72. However, futures contracts discussed in this paragraph 3.5.1 are confined to those traded on the exchanges.

[45] Currie, JS, *Australian Futures Regulation,* Longman Professional, Melbourne, 1994, 5.

[46] Currie, JS, note 45, 5. The futures exchanges in Australia are the Sydney Futures Exchange and the Australian Stock Exchange. This latter exchange operates a limited futures market known as the ASX Futures.

[47] Currie, JS, note 45, 21.

[48] This means the process of re-calculating the value of a contract according to its market value.

[49] Winstone, D, note 11, 60, 62 & 70.

3.5.2 Forward Contracts[50]

A forward contract[51] is an OTC contract which in essence is a futures contract except that a futures contract is traded on exchange. It is differentiated from a futures contract in that it is customised or tailored-made and is a contract between two principal parties one of whom agrees to buy and the other to sell a particular commodity, currency or other financial instrument at a specified price on a fixed future date. Forward contracts are frequently employed to manage foreign exchange (currency) risk. One of the more popular forms of forward contract is the forward rate agreement,[52] commonly known by its acronym of FRA. Another popular forward is the forward currency exchange contract. These forward currency contracts are often used by commercial banks and corporations to manage their exposure to fluctuating exchange rates in international investments, revenue flows and future liabilities.[53]

Forward contracts differ from futures in the following aspects:

1. They allow for the delivery of a physical commodity or a financial product at a future date. Futures are generally financial instruments which do not require the delivery of a physical commodity.[54]

2. Forward contracts can be negotiated on a one off basis. Futures, on the other hand, are standardised contracts. This ensures fungibility.[55]

3. Forward contracts, because they are generally not fungible, cannot be closed out while all future contracts can be closed out prior to the delivery date.

Forward contracts are regulated under Chapter 8 of the Corporations Law unless excluded from the definition of "futures contract" in section 72(1)(d) or if they do not fall within the definition in section 72. Those that are technically "futures contracts" may be partially regulated by the regime in Chapter 8 if they are granted exempt

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[50] Although a "forward exchange rate contract" and a "forward interest rate contract" (to which a bank is a party) are referred to and excluded as a futures contract by paragraph 72(1)(d) of the Corporations Law, a forward contract is not defined in that Law.

[51] The term "forward contract" is here given its ordinary meaning, as it is generally understood by the market participants.

[52] A contract in which two counterparties agree on the interest rate to be paid on a notional amount of specific maturity at a specific future time. Normally, no principal exchanges are involved, and the difference between the contracted rate and the prevailing rate is settled in cash - See McDougall, B, note 24, 85.

[53] McDougall, B, note 24, 85.

[54] Currie, JS, note 45, 5.

[55] Currie, JS, note 45, 5.

futures market status. Exemption frees the participants from complying with many of the requirements in Chapter 8 but does not prevent the sanctions regime from applying.

3.5.3 Options

An option is a contract which can be traded OTC or on exchange. It gives the purchaser, in consideration of a fee, the right to buy or sell an asset at a specif.ed price either on a fixed date (European Option) or by a certain date (American option). An option to buy is a call option while an option to sell is a put option. As options allow the buyer to gain from positive market movement, but not to lose if the market movement goes in the opposite direction, there is asymmetry of risks to the buyer and seller in that the seller could only lose but never gain from the market movement. Therefore, an option transaction will not, unlike most other types of derivatives, result in equal opportunity for the buyer and seller to gain (or lose).[56] In common with other derivatives contracts, options result in zero sum, that is, a gain by the buyer of the option is reflected as a loss to the seller.[57] OTC options are often used as tools to manage equity exposure.[58]

Options are of particular concern to regulators because the risks in them are more complex. The value of an option is calculated with reference to a set of theories and mathematical formula such as that devised by Professors Fisher Black and Myron Scholes.[59] The Black-Scholes model of pricing takes into consideration five "risk" factors, namely:

(i) the price of the underlying;
(ii) the exercise price of the option;
(iii) the time to expiration of the option;
(iv) the volatility of the price of the underlying; and
(v) the discount rate over the life of the option.[60]

The presence of these risk-factors requires that the risks in an options portfolio be managed continuously with a position in the underlying, a process termed dynamic hedging.[61] A second method of managing the risks in an options portfolio is to purchase other options as hedges.[62]

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[56] Galitz, L, note 13, 188-89.
[57] Loomis, CJ, 'The Risk That Won't Go Away,' *Fortune*, March 7, 1994, 40.
[58] Smithson, C, "Who Uses What," *Risk*, May 1996, 50.
[59] For a mathematical explanation of the Black-Scholes model, see Galitz, L, "10.7 Option Pricing - The Black-Scholes Model" in Galitz, L, note 13, 210.
[60] Group of Thirty, note 22, 45.
[61] Group of Thirty, note 22, 45.
[62] Group of Thirty, note 22, 46.

3.5.4 Swaps

A swap is a type of forward contract which involves the exchange of one type of cash flow, or asset, for another. It is commonly used as a tool for interest rate risk management. Swaps usually relate to:

(a) an exchange of two different types of interest rate, for example fixed rate in exchange for floating or vice versa;

(b) an exchange of the basis of the interest rate, for example, SIBOR[63] in exchange for HIBOR[64] or prime rate or composite rates of commercial papers or Certificates of Deposits;[65] or

(c) an exchange of currency, such as Swiss francs for Australian Dollars.

A swap transaction is between two parties, each having an equal but opposite need which could be assuaged by exchanging positions with each other. The notional amounts used in swaps are usually within the $5 million to $500 million range and the maturities are between one to twelve years.

3.6 Risks associated with derivatives

Although the risks associated with financial derivatives are the same as those encountered in other types of transactions such as bank loans, derivatives have a tendency to increase the risk profile of market participants,[66] due to certain characteristics of these instruments which are discussed below. The risks may be classified under six heads - credit risks, market risks, legal risks, operational risks, settlement risks and systemic risks.

3.6.1 Credit risks

Credit risks refer to the risks that a counterparty to a derivatives transaction will be financially incapable of performing its obligations under that transaction. Credit risks in relation to OTC transactions are generally higher than on-exchange transactions for several reasons. First, OTC transactions are entered into bilaterally and consequently the chances of default by a counterparty are higher than transactions carried out on organised exchanges.[67] This is because under the business rules of a clearing house, the clearing house is substituted as a counterparty to all contracts. The mechanism

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[63] Singapore Interbank Offer Rate.

[64] Hongkong Interbank Offer Rate.

[65] see Khambata, D M: *The Practice of Multinational Banking*, Quorum Books, New York 1986.

[66] Australian Securities Commission, 'Draft Report On Over-The-Counter Derivatives Markets', 1993 (ASC Draft Report), 12; ASC Final Report, note 2, 15.

[67] Abken, PA 'Over-the-Counter Financial Derivatives: Risky Business?', *Economic Review*, Federal Reserve Bank of Atlanta, Vol 79 No 2, Mar/Apr 1994, 1 at 12; Rule 603(c) Business Rules of the Malaysian Derivatives Clearing House Bhd.

dilutes the credit risks, because the risk of an individual counterparty's failure is replaced by the more remote risk of the clearing house's failure. Credit risk for on exchange transactions is further reduced by the clearing houses' generally more superior facilities, such as comprehensive risk management systems which have greater capacity to control risks more effectively than an individual counterparty. It is also reduced by rules aimed at correcting price fluctuations by requiring all contracts to be marked to market ie, the collection of variation margins which realises any losses or gains on a daily basis.[68]

Second, OTC contracts are generally entered into for a longer period than exchange traded derivatives contracts. The credit rating of a counterparty can deteriorate substantially over a short period of a few years and some OTC contracts go for ten years or more.[69] Of concern are the hedged funds or other pooled funds. These funds comprise contributions from a large number of investors who have the right to withdraw their money. If, for some reasons, members withdraw a sizeable amount of their investment, the funds may be unable to meet their obligations as counterparties. The creditworthiness of pooled funds, particularly those which invest heavily in derivatives, needs to be treated with caution.[70]

Credit risks are measured with reference to current and future exposures of a party to a derivatives contract. The credit risk of a transaction at a given point in time is the cost of replacing that transaction when the contract terminates. Therefore the current exposure of a derivative instrument is its mark-to-market value while its future exposure is the potential loss which may be incurred due to changes in the underlying prices or interest rates.[71] The assessment of potential exposure is difficult as prices and interest rates could fluctuate over time. A common method employed by dealers is the use of models which analyses the volatility of the underlying and the effect of its movements on the value of the derivative. Such models include the Monte Carlo[72] or historical simulation studies or option valuation models and are often used to generate both the "expected" and "worst case" scenario.[73]

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[68] Malaysian Securities Commission, 'Derivatives Dealings: Identifying the Risks', *Business Times*, April 26, 1995, 4.
[69] Loomis, CJ, note 57, 40.
[70] Loomis, CJ, note 57, 40.
[71] Abken, PA; note 66, 12.
[72] The Monte Carlo simulation approach involves simulating the path of the underlying asset at random over thousands of trials, and valuing the option on each occasion. An average of all the results of these trials is then worked out. It is thought that such an approach would provide a reasonable estimate of the fair value of an option. See Galitz, L, note 13, 303.
[73] Group of Thirty, note 22, 47.

Different types of derivatives attract different credit risk exposure. The potential exposure on interest rate derivatives is usually traced as a dome shaped curve, rising from the time of its origination and then falling towards its expiration. This may be explained by the fact that at the beginning there is little uncertainty as the information which led to its pricing is current but such information has less and less predictive value over time, resulting in uncertainty and therefore an increase in future exposure. However, as an interest rate contract has fixed maturity, the number of remaining future payments will fall nearer the expiry, thereby reducing the future exposure so that towards the end of the contract period, the two effects off-set each other.[74]

On the other hand, currency swaps exhibits a future exposure profile which rises from the point of origination. This is due to the fact that the exchange of principal, which constitutes the largest payment in the life of the contract, is at the end where there is the greatest probability of default. These two factors, the size of the payment as well as the time, with maximum exposure peaking only at the end of the swap's life, combined to make currency swaps a generally riskier proposition than the interest rate swap.[75]

Private rating agencies such as Moody's and Standard & Poor play an important role in the management of credit risks. These agencies provide the credit ratings of issuers of derivatives products as well as derivatives that have been issued by banks and other issuers. By putting a credit rating on banks and other organisations, and by grading the derivatives that are issued, investors will be able to gauge their credit risk in a particular OTC transaction. The highest possible credit rating that may be given is AAA or triple A. Derivatives with triple A ratings include Morgan Stanley Derivatives Products, Goldman Sachs Financial Products, Salomon Brothers Special Purpose Derivative Vehicles and Paribas Special Purpose Derivative Vehicles.[76]

Recent emergence of a new breed of structured derivatives known as credit derivatives are expected to help revolutionise the management of credit risks. By the use of a credit derivative contract, credit risk is transferred from one party to another. About five years into their development, the market has come up with standardised and reasonably priced credit derivatives that a commercial bank may purchase to minimise or even eliminate their credit risks. These instruments have hundreds of possible applications; to reduce credit exposure to a single debtor, to eliminate sovereign risks and to free up credit lines to particular sectors. By their usage, banks are able to off

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[74] Abken, PA; note 67.
[75] Abken, PA; note 67.
[76] Crawford, G & Sen, B, note 30, 150.

load existing risks in order to take on new business transactions.[77] Their potential use is so pervasive and their growth so rapid that they may overshadow traditional derivatives. Although still in infancy, the volume of transactions for credit derivatives was estimated by KPMG Canada in September 1996 to have reached US$50 billion in notional amounts.[78]

Additionally, there is potential for reducing credit risks in employing the Value At Risk (VAR) model now fast gaining acceptance as an model to quantify market risks.[79] It has been argued that VAR model for measuring market risks can also be used to create an integrated framework for market and credit risks and that as a result credit risks is becoming much more quantitative and automated.

Further, credit risks may be reduced, in relation to a portfolio of derivatives, by set-off or "netting" arrangements made between counterparties. If a party is able to net against its counterparty gains which have been made in one transaction against any losses in another transaction with the same counterparty, then the amount due will be much reduced and the credit exposure of each party will be smaller. Whether netting applies is determined by the terms of the master agreement governing the relationship between the parties. Typically the agreement provides for all outstanding transactions to be terminated and marked to market in the event of a counterparty defaulting.[80] Netting is then effected by aggregating all the positive and negative mark-to-market values of the transactions within the portfolio. The problems concerning netting is discussed in the section under legal risks below.

3.6.2 Market risks

Another important risk which must be managed by OTC participants is market risk. Market risk refers to adverse price movement of a derivative due to market conditions dictated by the laws of supply and demand or some other factors. These risks exist in most investments regardless of whether derivatives are used. Many derivatives products involve a greater degree of market risks for a number of reasons. First, there is the existence of basis risk or correlation risk. The term "basis risk" is used to describe the risk that on settlement of a transaction, a difference may arise when the commodity being hedged is not exactly the same as the underlying asset. For example, if oil of one quality is required to be hedged but the futures contract entered into

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[77] Parsley, M, 'Credit Derivatives Get Cracking', *Euromoney*, March 1996, 28.
[78] KPMG Canada, 'Treasury Risk Management Dervices: The Hedge', September 1996 (http://www.kpmg.ca/trm/sept_96.htm).
[79] Spinner, K, 'Integrating Credit and Market Risks', CATS 1 April 1996 (http://www.cats.com/cats/catsdt1.shtml).
[80] Group of Thirty, note 22, 44; Abken, PA; note 67.

relates to oil of another quality, the prices of the two types of oil will not be perfectly correlated, thus giving rise to basis or correlation risk.[81] Second, there is market liquidity risk, which is the risk that, in an illiquid market, a derivative instrument will cost more than it should, had the market been normal.[82] A single derivative contract, if sufficiently large, may possibly have an impact on the liquidity of the market. The likely consequence of an erosion of liquidity is an increase in the cost of hedging.[83] Markets which traditionally are not very active, such as the derivatives of minerals or of energy, are more susceptible to market liquidity risk.[84] Third, market risks in derivatives are magnified because they are leveraged. Fourth, some derivatives create market risks simply because they are difficult to calculate or to value.

The market risk of derivatives products differs according to whether the derivatives contracts are forward based or option based. Forward based derivatives have a simple market risk profile and do not generally have significant gamma risk.[85] The main market risk to which they are exposed is absolute price or rate risk.[86] A shift in price of the underlying asset is reflected in proportional changes in the derivatives.

On the other hand, option based derivatives have complex market risks. Unlike forward based derivatives, a change in the price of a derivative need not result in a proportionate change in the price of the underlying asset. Their complexity makes valuation difficult. There are however well developed mathematical models such as the Black-Scholes model which enable these options to be valued.

In managing market risks of a portfolio of derivatives or the risks in option contracts, a participant must identify the fundamental risks the portfolio or option contains so that the risks can be split into component parts. The fundamental risks that may be identified include:[87]

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[81] Daugaard, D, & Valentino, T, note 9, 92-93.
[82] Hu, H, 'Misunderstood Derivatives: The Causes of Informational Failure and the Promise of Regulatory Incrementalism', *Yale Law Journal*, Vol 102, No 6, 1457-1513, April 1993, 1457.
[83] Group of 30, note 22, 46.
[84] ASC Final Report, note 2, 18.
[85] Gamma risk is defined as the change in delta for a unit change in the underlying asset price.
[86] Group of 30, note 22, 44.
[87] Although these fundamental risks are mainly used in relation to options, they are also used to determine the net risk position of a portfolio of derivatives so as to better manage such risks. See Group of 30, note 22, 43.

(a) Delta risk[88]

This risk concerns a change in value of an underlying asset which in turn causes a change in the value of the derivatives instrument. It is expressed as a decimal fraction of that change.[89] Delta varies between zero and one.[90] A swap usually has a delta of one while an option with a strike price set at the forward rate would have a delta of about one-half.[91] The measurement of delta risk is of particular relevance to options since it defines exactly the extent to which the option price will move when the underlying asset price changes.[92]

(b) Gamma risk

Also known as convexity risk, it is defined as the change in delta for a unit change in the underlying asset price.[93] Given that delta is the most important measure of an option price sensitivity, gamma serves a useful function by tracking how delta is affected by movements in the price of the underlying asset.[94] Gamma arises when the relationship between the price of an underlying asset and the value of a transaction is not linear.[95] The greater the non linearity, the greater the risk.[96] In general, the sensitivity of an option's price to changes in the price of the underlying asset varies with the price of that asset. It is not an uncommon phenomenon in call options that the higher the option price moves above its strike price, the greater is the option's sensitivity to the price of the underlying asset so that any increase in the underlying is sometimes matched by an equal increase in the option price.[97]

(c) Vega risk[98]

Vega or "kappa",[99] as it is sometimes known, is the response of an option to volatility. Vega risk is typically associated with options and arises from a change in the value of a transaction or a portfolio consequent upon a change in

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[88] Galitz, L, "Options - From Basics to Greek" in Galitz, L, note 13, 242; This risk is also known as absolute price or rate risk, see Group of Thirty, note 22, 44.
[89] Carew, E, *Derivatives Decoded*, Allen & Unwin, Sydney, 1995, 122.
[90] Group of 30, note 22, 44 at footnote 12.
[91] Group of 30, note 22, 44 at footnote 12.
[92] Galitz, L, "Options - From Basics to Greek" in Galitz, L, note 13, 242.
[93] Galitz, L, "Options - From Basics to Greek" in Galitz, L, note 13, 241.
[94] Galitz, L, "Options - From Basics to Greek" in Galitz, L, note 13, 246.
[95] The term "non linear" refers to options and other derivatives with option features. See Abken, PA; note 67.
[96] Group of 30, note 22, 44.
[97] Some exchange traded stock or share call options exhibit this phenomena.
[98] Galitz, L, "Options - From Basics to Greek" in Galitz, L, note 13, 244; Abken, PA; note 67.
[99] Carew, E, note 89, 123.

the expected volatility of the price of the underlying.[100] It measures the change in the option price given a change in volatility of the underlying asset.[101] An option which exhibits volatility is expected to increase in price because volatility means uncertainty and therefore the greatest possibility of a gain at maturity. The greater the volatility, the higher the price of an option. However, volatility of an option need not be a reflection of the underlying asset because it is possible to have a shift in volatility without any change in the price of the underlying.[102]

(d) Theta risk[103]

Theta is a measure of time decay and defines how much value is lost from the price of an option by effluxion of time. Theta risk arises from the exposure of an option or a portfolio of options to a change of value due to the aging of the option or options. Theta may be expressed as am amount in dollars per day representing the expected change in the value of the option contract.[104]

(e) Rho risk

Rho or "iota"[105] is used to denote a change in the premium of an option for a unit change in interest rate. The risk refers to the exposure to a change in the value of a derivative or a portfolio by reason of a change in the interest rate used for discounting cash-flow.[106]

The ability to analyse derivatives risks in terms of individual risk components allows the risks to be aggregated and repackaged for better management of those risks. This ability is a key feature of derivatives and has been attributable to the rapid growth of those instruments.

3.6.3 Legal risks

Legal risks fall into two categories; the risk of criminal prosecution or of incurring a criminal sanction and secondly, the risk of loss by reason of a transaction being unenforceable. Criminal liability may be incurred, for example, by contravening the *Unlawful Games Act 1984* (ACT) which makes it an offence for a person to engage in any "game of skill or chance or of mixed skill and chance, in which money or other

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[100] Group of 30, note 22, 44.
[101] Carew, E, note 89, 123.
[102] Abken, PA; note 67.
[103] Galitz, L, "Options - From Basics to Greek" in Galitz, L, note 13, 243.
[104] Carew, E, note 89, 122.
[105] Carew, E, note 89, 123.
[106] Group of Thirty, note 22, 44.

valuable thing is staked or risked upon an event or contingency".[107] It is conceivable that some derivatives contracts would fall within the ambit of section 6 of the *Unlawful Games Act 1984* (ACT). Although sections 778 and 1141 of the Corporations Law[108] protect all options contracts traded on a stock exchange or an exempt market and all futures contracts from illegality, they are not wide enough to exclude all derivatives contracts. A party to a transaction which falls outside the scope of sections 778 or 1141 of the Corporations Law and which contravenes State gaming and wagering legislation may be subject to criminal sanctions under those laws. A good example is a contract referred to in paragraph 72(1)(d), that is an interest rate swap, currency swap, forward exchange rate contract, or forward interest rate contract to which a bank or a merchant bank is a party. As these contracts are not futures contracts by definition, section 1141 will not apply to them.[109]

Other than gaming and wagering, a trader in certain circumstances may breach the provisions in Chapter 8, and in particular, section 1123 of the Corporations Law. This section prohibits unauthorised futures markets.[110] The wide definitions given to "futures contract" and "futures market" in the Corporations Law give rise to a concern that Chapter 8 regulates OTC transactions,[111] including those that are carried out between companies in a corporate group by the group treasury.[112] Although subsection 103(2) of the Corporations Law provides that a contravention of Chapter 8 will not render a contract invalid, it does not save the participants from criminal penalty. This problem is expected to intensify as a result of market and product innovation.

The second category of legal risks, the risk of economic loss due to the unenforceablity of a contract, may arise from a variety of contractual issues, including the following:

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[107] Section 6 *Unlawful Games Act 1984* (ACT).

[108] Section 1141of the Corporations Law provides that "Nothing in a law of this jurisdiction about gaming or wagering prevents the entering into of, or affects the validity or enforceability of a futures contract made: (a) on a futures market of a futures exchange ...; or (b) on an exempt futures market; or (c) as permitted by the business rules of a futures association, of a futures exchange or of a recognised futures exchange." Section 778 provides much the same (as section 1141) in relation to an option contract entered into on a stock market of a securities exchange or an exempt stock market.

[109] Currie, JS, note 45, 45.

[110] The penalty for this offence is 200 penalty units and/or imprisonment for 5 years.

[111] Policy Statement 70, note 27, paragraph 21.

[112] Recognising this as a problem, the ASC in its Policy Statement 70, note 27, at paragraphs 66 - 69, advised that it sees no benefit in enforcing the provisions of Chapter 8 of the Corporations Law in relation to intra group transactions. See also ASC Final Report, note 2, paragraph 168.

(a) Illegal or void contracts

Where a contract is made in contravention of legislation, it is illegal and therefore void except where legislation provides otherwise. Subsection 103(2) of the Corporations Law changes this position by stipulating that an act, transaction, agreement, instrument, matter or thing is not invalid merely because of a contravention, inter alia, of Chapter 8. This means that a derivatives contract which breaches a provision in Chapter 8 will not be invalid and will be enforceable even though the sanctions regime in Chapter 8 continues to apply to such a contract.

However, derivatives are evolving at a rapid pace and the legality of many new instruments has not been tested. If a derivatives product which is regulated by Chapter 8 of the Corporations Law is found to have contravened some laws other than Chapter 8, subsection 103(2) of the Corporations Law will not be able to save it from the consequences of illegality. This is because the resulting invalidity is not due to a contravention of Chapter 8 but of other laws. Such a derivatives instrument runs the risk of being declared by the courts to be illegal and consequently void and unenforceable.

Further, a number of OTC contracts are not within the ambit of the Corporations Law[113] and as such, these contracts are not entitled to the protection afforded by sections 778 and 1141. This group of contracts would be illegal and unenforceable if they contravene any State or Commonwealth laws.

(b) Ultra Vires

An important principle of contract law is that parties to a contract must have the capacity to enter into it. Where one of the parties to a contract does not have the capacity or authority to do so, that contract is said to be an ultra vires transaction and is void. A trustee of a trust or a superannuation fund who is not empowered by the terms of the trust to enter into derivatives contracts will be in breach of trust if it does so. The counterparty in such a transaction becomes a constructive trustee of any money received from the trustee if it has actual, constructive or imputed notice that the money is trust property.

113 As they are not governed by the Corporations Law, the issue of contravening a Chapter 8 provision does not arise and therefore subsection 103(2) of the Corporations Law will have no application.

Moneys which have been transferred in breach of trust are liable to be repaid to the trust.

Similarly, local authorities such as town or city councils would be legally incapable of entering into derivatives contracts unless empowered by their enabling legislation. A case in point is *Hazell* v *Hammersmith and Fulham London Borough Council and Others.*[114] In 1983, the Council, which was incorporated as a royal charter under the London Government Act 1963, established a capital market fund for the purpose, inter alia, of speculating on interest rate movements. Between 1987 and 1988, the Council conducted a range of derivatives transactions including interest rate swaps, swap options, interest rate caps, floors and collars, forward rate agreements and gilt and cash options. The Council's activities on the capital market were challenged by the auditor appointed by the Audit Commission on the basis that the interest rate swaps amounted to speculative trading since no attempt had been made to match actual debts and investments with any of the transactions entered into by the Council.

It was held by the House of Lords that the Council had no power to enter into swap transactions, which by their nature involved speculation in future interest trends because they were inconsistent with the borrowing powers of a local authority as defined in the Local Government Act 1972.[115] The House of Lords also found that those swap transactions were not saved by section 111 of the 1972 Act (which allowed a local authority to do anything which facilitates the discharge of its functions) because they did not facilitate nor were they conducive to the discharge by the Council of its borrowing functions. As a consequence, the Council was not liable to honour contracts made.[116]

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[114] [1990] 3 All ER 33.

[115] *Hazell v Hammersmith and Fulham London Borough Council and Others*, [1991] 1 All ER 545; see also [1990] 3 All ER 33 (Court of Appeal). Mention should be made of a subsequent decision of the House of Lords in *Westdeutsche Landersbank Girozentrale v Islington London Borough Council* (1996) 2 All ER 961 where their Lordships held that as no consideration had been given for an ultra vires contract, the money paid was recoverable.

[116] The House of Lords, in holding that the contracts were ultra vires local authorities and therefore void, left open the question whether payments made pursuant to such ultra vires contracts were recoverable or not (see *Westdeutsche Landersbank Girozentrale v Islington London Borough* (1996) 2 All E R 961 per Lord Browne-Wilkinson at 982). However, it would appear that the parties treated the monies as irrecoverable as it was reported in Group of Thirty, note 22, 51 that this decision resulted in huge losses to the swap dealers who were its counterparties.

Although the ultra vires principle, in its application to companies, has been virtually abolished in Australia,[117] it still is effective in relation to certain corporations which are not companies as defined in s.9 of the Corporations Law. Examples of corporations which are not companies include incorporated associations[118] and foreign companies.[119] It is also of relevance in certain jurisdictions where the capacity of a company to enter into derivatives contracts is determined by the object clauses in its memorandum of association. An Australian company entering into a derivatives contract in Australia with an incorporated association or with a foreign company or alternatively entering into an offshore derivatives contract with a company incorporated in a jurisdiction which still recognises the ultra vires principle will run the risk of the contract being declared unenforceable if that counterparty is not empowered by its memorandum of association to trade in derivatives.

(c) Insolvency of the counterparty

The bankruptcy or insolvency of a counterparty creates the opportunity for "cherry-picking", that is, the avoidance of onerous transactions. The insolvency laws of Australia allow the liquidator of a company to disclaim properties which are not beneficial to that company. Derivative contracts which are executory in nature and which are deemed to be unprofitable may be avoided by the liquidator of a company under paragraphs 568(1)(d), (e) or (f) of the Corporations Law.[120] Similarly, provisions in the *Bankruptcy Act 1966* (Cth) entitle a trustee in bankruptcy to disclaim contracts or properties.[121] In the event of the bankruptcy or insolvency of a counterparty, its trustee or liquidator would have the option of deciding to keep only those contracts which are profitable while disclaiming liability on those others which are disadvantageous to the estate of the bankrupt or to the company.

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[117] Section.160 and subsection.162(5) of the Corporations Law; see also the discussion on ultra vires in Tomasic, R, et al., Corporation *Law: Principles, Policy and Process,* Second Edition Butterworths, Sydney 1992, 170-71; see also Bull, K, 'Does Government Have a Future in Derivatives?' *ABLR*, Vol 25, August 1997, 246 at 252.

[118] Incorporated associations are exempt bodies within the meaning of section 66A of the Corporations Law and an exempt body is excluded from the definition of "corporation" in section 9. The view that incorporated associations are not companies appears to be confirmed in the discussion in Phillips, J & O'Donovan, J, *The Modern Contract of Guarantee*, second edition, the Law Book Company Limited, Sydney, 1992, 47.

[119] Foreign companies are not companies within the meaning of section 9 of the Corporations Law because it is not a company incorporated or taken to be incorporated under the Corporations Law.

[120] Section 568, in essence, provides that a liquidator may at any time in writing disclaim property that consist of "(d) property that may give rise to a liability to pay money or some other onerous obligation; or (e) property where it is reasonable to expect that the costs, charges and expenses that would be incurred in realising the property would exceed the proceeds of realising the property; or (e) a contract".

[121] See sections 133(1AA), 133(1AB), 133(1), 133(1A) of the *Bankruptcy Act 1966* (Cth).

In addition to the disclaimer of onerous contracts, insolvency laws create potential legal risk in situations where the doctrine of relation-back[122] or where the doctrine of preferences[123] applies. A derivative transaction falling within any of those situations may be void against the trustee in bankruptcy even though it has been completed. This is because in the case of a relation back, any purported disposition of property by the debtor, such as the payment of money to settle a derivatives contract, will be ineffective, for property in the goods is vested no longer in that debtor but in the trustee in bankruptcy. In the case of preference, any payment made which has the effect of giving that creditor a preference or advantage over other creditors will be void against the trustee. Parallel provisions exist in the Corporations Law in relation to companies.[124]

The practical effect is that where payments have been made to a counterparty under a derivatives contract which is ineffective by virtue of the operation of bankruptcy or insolvency laws, those payments may have to be refunded to the trustee in bankruptcy or liquidator of an insolvent debtor. In these situations, the position of the solvent party is no better than that of an unsecured creditor. Any outstanding rights it has under the contract will rank pari passu with that of the other creditors of the debtor.

The operation of these insolvency doctrines may have a direct impact on netting arrangements. Netting allows parties to two or more transactions to offset payments[125] so that the parties are liable only to the final figure, after taking into account contra payments. Master agreements incorporating netting provisions have been employed as a mechanism by which a party's financial exposure to risk may be reduced. This strategy will be rendered ineffective if those bilateral close out netting provisions are held to be invalid and unenforceable by the courts by reason of the operation of the doctrines of relation-back and of preferences. If netting provisions are not recognised, the solvent party will be left with a higher exposure than had been anticipated.[126] This could increase systemic risk and have serious implications for the health of

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[122] Commencement of bankruptcy is deemed to relate back to the first act of bankruptcy committed by the debtor within 6 months prior to the creditor's petition: section 115 *Bankruptcy Act 1966* (Cth); but see also section 123 *Bankruptcy Act 1966.*
[123] Section 122 *Bankruptcy Act 1966* (Cth).
[124] Section 588FA Corporations Law.
[125] ASC Final Report, note 2, paragraph 84.
[126] Abken, PA, note 67.

the capital markets in the event of the failure of a big conglomerate or derivatives dealer.[127]

(d) Crown immunity

It is a general principle of law that the Crown is entitled to be immune from suits. Crown immunity derives its origins from the feudal principle that a lord could not be sued in his own court.[128] Today, the Crown is equated with the executive branch of the government,[129] and includes agents of the Crown. The extension of the shield of the Crown to government agencies could pose a legal risk for a party contracting with a Crown agent as a counterparty, as the Crown is immune from liability and theoretically, though highly unlikely, could renege on a derivatives contract. However, the immunity can only be claimed by an agency which is controlled by a Minister.[130] In some jurisdictions, such as the Australian Capital Territory in Australia, the Crown is divested of its immunity by section 7 of the *Interpretations Act 1967* (ACT), except for such immunity as are expressly preserved by legislation.

(e) Oral contracts

Given the large volume of derivatives contracts, there is a possibility that documentation for OTC contracts could be delayed, simply because of the sheer size. The concern is that if too much time is allowed to pass, there is a risk that a counterparty who is at the losing end of the oral contract could deny the existence or dispute the terms of that contract.

3.6.4 Operational risks

Operational risk is defined as the risk of loss that arises through inadequate systems or controls, management failure or human error.[131] Although the risk is encountered in all businesses, it poses a greater threat in relation to derivatives due to the complexity of derivatives instruments. Managing operational risks requires adequate control and supervision of trading activities by qualified personal, clear reporting lines, clear lines of accountability and the separation of trading functions from back-room functions. The failure to implement effective checks or organisational controls was blamed for the collapse of Baring Futures (Singapore) Pte Ltd.[132] Similarly, the deficiencies in

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[127] One such derivatives dealer is the Chemical Bank, which is said to have about US$2.5 trillion of derivatives contracts on its books. In the event of a severe financial crisis, the failure of a big player could cause a systemic failure of the financial system. See Loomis, CJ, note 57.

[128] Hogg, PW, *Liability of the Crown*, the Law Book Company, NSW, 1989, 3-4.

[129] Hogg, PW, note 128, 9; see *Town Investments* v *Department of Environment* (1978) AC 359, 397.

[130] Hogg, PW, note 128, 250-53.

[131] Group of Thirty, note 22, 50.

[132] Lim, M & Tan, N, *Baring Futures (Singapore) Pte Ltd: The Report of the Inspectors Appointed*

the company's system of recording foreign exchange dealings and the inadequacy of its internal control was said to be a significant factor in the losses incurred by AWA Limited.[133]

The Group of Thirty, in their report entitled 'Derivatives: Practices and Principles', published in July 1993, identified a number of internal controls to help manage operational risks. These include:

- "Oversight of informed and involved senior management.
- Documentation of policies and procedures, listing approved activities and establishing limits and exceptions, credit controls and management reports.
- Independent risk management function (analogous to credit review and asset/liability committees) that provides senior management validation of results and utilisation of limits.
- Independent internal audits which verify adherence to the firm's policies and procedures.
- A back office with technology and systems for handling confirmations, documentation, payments, and accounting.
- A system of independent checks and balances throughout the transaction process, from front-office initiation of a trade to final payment settlement."[134]

In addition to the list outlined above, adequate internal controls would encompass a sufficiently comprehensive accounting and disclosure requirements. What all this means is that both structural (such as those enumerated in dot points 1, 3 & 4) as well as procedural controls (examples of which are dot points 2, 5 & 6) must be in place if such risks are to be managed adequately. It is a fundamental principle of prudent business practice, one which is universally employed by banks, that the trading activities of the firm should be subjected to a system of checks and balances throughout the transaction process, from the initiation of a trade, to its settlement. One feature of structural control is the oversight by senior management of the company's derivatives activities. It is essential that directors have a good appreciation of the derivatives transactions entered into by their company and the risks involved even though they may not be fully conversant with the technical aspects of trading and procedures.[135] Another essential feature is the separation of the risk management and

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by the Minister for Finance, Ministry of Finance, Singapore, 1995, 39.

[133] *Daniels & Ors (formerly practising as Deloitte Haskins & Sells) v Anderson & Ors; Hooke v Daniels & Ors (formerly practising as Deloitte Haskins & Sells); Daniels & Ors (formerly practising as Deloitte Haskins & Sells) v AWA Ltd*, (1995) 13 ACLC 615.

[134] Group of Thirty, note 22, 50.

[135] Malaysian Securities Commission, 'Malaysia: Aspects of Operational Risks', *Business Times*,

audit functions from the trading functions of the company. It has been suggested[136] that the risk management and audit departments should report directly to the top management whose remuneration should not be directly dependent on trading profits. This is unlikely to be achievable in the case of a large number of companies as the remuneration of chief executives is invariably tied to their company's profit performance.

Procedural control focuses on the handling of the various aspects of the derivatives trade, such as the placing of trading orders, trade confirmations, documentation, payments, accounting and audit trail. These controls should be documented so that management and employees clearly understand the nature, function and their respective roles in the administration of the controls.

For effective risk management where the company is speculating or making a market,[137] it is important that the company's internal policies and procedures be established with regard to the maximum trading limits, both in relation to each individual trader and where applicable, to the types of derivatives instrument. It is a pre-requisite of good risk management that updated and modern technology and systems be acquired so that human errors can be minimised and risks more accurately analysed.

Operational risks of organised exchanges are well managed as regulations and the business rules of clearing houses require futures brokers to segregate the funds of their clients, to comply with capital adequacy and liquidity requirements and to have in place adequate audit procedures. A counterparty trading on an exchange must nevertheless ensure that it adopts good corporate governance practices to minimise operational risk within its own organisation.

3.6.5 Settlement risk

Also sometimes known as Herstatt risk, this is the risk of default at or about settlement and may occur because of time differences or other factors. For example, if a derivatives contract is entered into between two parties living half across the world from each other, an exchange may not be made simultaneously. A party who has fulfilled its obligation may nevertheless be required to wait for payment or delivery of

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May 24, 1995 (MSC Operational Risks), 4.

[136] MSC Operational Risks, note 135.

[137] Where the company is an intermediary, it may need to take a position if there is no market or the market is thin. If no counterparty is found, the company - in order to facilitate its role as intermediary - may itself enter into the contract as the counterparty and thereby assumes a risk.

securities from the other counterparty. This exposes the counterparty who has performed its part of the contract to a risk, ie, the default of the counterparty.

Settlement risk is exemplified by the failure of the Bank Herstatt, a German bank, in June 1974. The Bank received marks from New York banks for its foreign exchange transactions but had not yet paid the counterparty banks in dollars. The dollar payments were scheduled to be made after the close of business in Germany. At the close of business on 26 June 1974, the German banking authorities permanently closed Bank Herstatt, making it impossible for the counterparties to be paid.[138]

3.6.6 Valuation risks

In addition to the risks highlighted above, there is the risk that the profits of a transaction may be misstated. The normal practice for updating the value of a dealer's derivatives portfolio is to mark it to market. While there is no difficulty in determining the market price of an on exchange contract, the valuation of OTC contracts is problematic. The difficulty with a re-valuation of OTC derivatives contracts is that judgments about what the market value is can vary widely as these derivatives are not readily priced because they are traded in an illiquid market where only a few transactions take place.

Without the mechanism of an organised exchange, it would be difficult to determine with any degree of accuracy the real value of a derivatives contract at a particular point in time. The value of many derivatives is found by the use of mathematical models that must include an estimate of what the volatility of the underlying will be over the term of the contract. However, estimates of volatility can differ because vega risk can be measured in different ways, giving rise to different valuations.[139]

3.6.7 Contagion risks

Where there are a large number of failures in one market, it is conceivable that these failures will affect related markets. For instance the failures in a futures market may spread to the underlying physical or commodity market. The risk that failures in a derivatives market adversely affecting related markets is known as contagion risk.[140]

3.6.8 Systemic risks

Systemic risk is the most dreaded of all the risks associated with derivatives because its effects can be catastrophic. It has been defined as "the risk that a disruption (at a

[138] Abken, PA, note 67 1.
[139] Loomis, CJ, note 57, 40.
[140] CASAC OTC DP 1995, note 25, 11.

firm, in a market segment, to a settlement system, etc.) causes widespread difficulties at other firms, in other market segments or in the financial system as a whole"[141] It raises the concern that defaults on derivatives contracts may trigger a chain reaction which could cause failures in other institutions and perhaps even the entire financial system, thereby putting at risk superannuation funds, insurance funds, bank deposits and even tax payers' funds, in cases where governments are compelled to come to the rescue. The costs, in economic terms, could be enormous.

Although there has not[142] been a systemic crisis[143] that can be attributable to derivatives,[144] systemic risk is a major concern for regulators and market participants for several reasons. As noted above, it is potentially the most dangerous of the risks confronting the capital markets because its ripple effect could affect the most number of investors. Second, because systemic risk arises from day to day trading activities, there is simply no way to guarantee that a systemic crisis will not occur.[145] The risk may be difficult to eliminate without restricting the trading of derivatives on the markets.[146] Third there are a number of factors which, individually or in combination, could trigger a systemic crisis.[147] Some of these factors are:

(a) Market linkages

The use of derivatives instruments does not eliminate risks but those risks are transferred to one or more counterparties anywhere in the world who in turn may pass them on to others. What results is a market of many interconnections[148] linking participants from different geographical areas of the world and different markets. The concern is that in the event of the default of a substantial dealer or participant, the existence of these linkages will help to

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[141] This quotation was attributed to the report of the Bank for International Settlement, (see BIS 1992, note 2) quoted in Group of Thirty, note 22, 61 & 127.

[142] This could happen with the failure of a large bank or other derivatives participant. The bailout for Resolution Trust Corporation in United States, although not due to derivatives trading, costs over US$87 billion by 1993. Another US$20 billion to US$ 50 billion was estimated to be required to complete the bailout. The Federal Government was compelled to come to the rescue: see Van Dyk, T, 'S&L Saga Ending; Regulatory Era Looms', *Financial World* Vol 162 No 1, January 1993, 17.

[143] This has been defined in BIS 1992, note 2, quoted in Group of Thirty, note 22, 127 as "A disturbance that severely impairs the working of the financial system and, at the extreme, causes a complete breakdown in it. Systemic risks are those risks that have the potential to cause such a crisis. Systemic crises can originate in a variety of ways, but ultimately they will impair at least one of three key functions of the financial system: credit allocation, payments, and pricing of financial assets. A given financial disturbance may grow into a systemic crisis at one point in time but not another, depending on the financial and economic circumstances prevailing when the shock occurs."

[144] Abken, PA, note 67.

[145] Abken, PA, note 67.

[146] Group of Thirty, note 22, 61 & 127.

[147] Abken, PA, note 67.

[148] Abken, PA, note 67.

transmit the shock faster and to a greater number of parties with dealings in the capital markets.[149]

(b) Market concentration

At a hearing before the United States Subcommittee on Environment, Credit and Rural Development of the Committee on Agriculture[150] James Bothwell[151] testified that the OTC derivatives activity in the United States ("US") was concentrated among fifteen US dealers[152] that were extensively linked to one another and to end users and the exchange traded markets. The concentration, coupled with the linkages could cause liquidity problems in the capital markets should a large dealer fail or withdraw abruptly from trading. Such a failure could pose a risk to a national or even global financial system.[153]

(c) Complexity

Many of the derivatives created in recent years are complex. Complexity in derivatives is unavoidable given that they are created to manage complex risks. However, investor's lack of knowledge is a cause for concern as huge losses could be made through wrong strategies in dealings based on inadequate understanding of derivatives.

(d) Non-transparency

A major concern which could cause systemic risk is the lack of transparency in the disclosure of derivatives position in accounts. The Group of Thirty in its Working Paper of the Accounting and Reporting Subcommittees reported[154] that over 40% of dealers and over 70% of end users do not describe their accounting policies for derivatives. There is a perception that accounting and disclosure of derivatives positions presently adopted by firms are inadequate.[155] Deficiencies in disclosure could increase the likelihood that the

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149 Group of Thirty, note 22, 63.
150 United States House of Representatives, note 19, 8.
151 Director of Financial Institutions and Markets Issues of the US General Accounting Office.
152 This evidence appeared to have contradicted the report of the Group of Thirty, note 22, which, basing its data from *The World's Major Swap Dealers*, Swaps Monitor Publications, Inc., November, 1992, asserted at p. 61 that "A survey based on data from annual reports of dealers indicates that the top eight dealers accounted for only 58% of the interest rate and currency swap markets at year end 1991. No firm in that survey had over 10% share of the market."
153 United States House of Representatives, note 19, 8.
154 See Group of Thirty, Global Derivatives Study Group, 'Working Paper of the Accounting and Reporting Subcommittees' in Derivatives: Practices and Principles - Appendix 1, Washington, 1993, 91.
155 Abken, PA, note 67.

accounts will not give a true and fair view of the firm's financial position. The lack of standard accounting rules on derivatives would greatly reduce the comparability of financial reports.[156]

(e) Largely unregulated OTC market

OTC derivatives traders are not subjected to the same regulatory burdens that are borne by on exchange derivatives traders. A trader could therefore deal on the OTC market with less restrictions. As the OTC markets remain largely unregulated, there is concern that the imprudent use of derivatives, such as taking large speculative bets on an underlying, could cause the demise of an institution and in so doing, create a systemic crisis.[157] For example, if a dealer with standing equivalent to the Chemical Bank, the world's largest dealer in derivatives,[158] were to collapse with trillions outstanding, it is conceivable that a systemic crisis could occur.

3.7 Conclusion

This Chapter has provided an overview of financial derivatives. It explained what they are, their classification, why they are important, their economic relevance and summarised the more significant risks associated with their use. The discussion on basic derivatives highlighted, where appropriate, the characteristics which could give rise to regulatory concerns. These issues will be revisited later in the final Chapter of this thesis.

As a prelude to the analysis carried out in Chapters 5, 6 and 7 of this thesis, the next chapter commences with an outline of the regulatory framework governing the OTC derivatives products.

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[156] United States House of Representatives, note 19, 9.

[157] Abken, PA, note 66.

[158] Chemical Bank is reported to hold about US$2.5 trillion in derivatives contracts on its books in 1993. See Loomis, CJ, note57, 40.

CHAPTER 4

THE REGULATORY FRAMEWORK AND NATURE OF DERIVATIVES REGULATION

4.1 Introduction

In the previous Chapter, it was established that the regulatory treatment of derivatives depends on whether they are OTC or exchange traded. The grouping of financial derivatives according to the market in which they are traded appears to be logical as different regulatory regimes and settlement systems apply to each market. Also, the classification is appropriate in terms of the characteristics of the contracts. For example, exchange traded derivatives contracts are readily distinguishable from OTC contracts in that all exchange traded contracts have the characteristic of fungibility, are required to be marked-to-market, and may be closed out at any time. On the other hand, an OTC contract, containing as it does terms and conditions specific to the needs of the two parties to the contract, is rarely identical in all respects with another contract even though its terms and conditions may have been drawn from a particular format, such as the ISDA[1] agreement.

It has also been observed in Chapter 3 that any derivatives contract which is not traded on exchange is an OTC contract. The OTC market in Australia is enormous, as a survey of 128 financial institutions indicated that the aggregate notional principal amount of off-exchange contracts outstanding as at 31 March 1995 was US$955.4 billion.[2] Although not directly comparable,[3] the outstanding on-exchange contracts amounted to US$258 billion in notional principal amount.[4]

This chapter seeks to provide an outline of the basic regulatory structure in Australia as an understanding of the regulatory framework is essential to the detailed analysis undertaken in the next three chapters. Chapter 5 analyses the Corporations Law regime, Chapter 6 looks at the extent to which protection is provided to investors under general criminal and consumer laws and Chapter 7 is concerned with the analysis in the supervisory structure. The objective of these Chapters is to identify the

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[1] International Swap Dealers Association, Inc.

[2] Reserve Bank of Australia, 'Survey of Derivatives Market Activity in Australia', Media Release No 95-21, 19 December 1995, Table 1. The figure is derived by subtracting, from the overall total of US$1,213.4 billion, those amounts which are attributable to futures and exchange traded option.

[3] This is because some of the component figures have not been adjusted for local dealer double counting - see Reserve Bank of Australia, 1995, note 2, Table 1, note (b).

[4] Reserve Bank of Australia, 1995, note 2, Table 1.

deficiencies in the regulatory framework to determine their impact on investor protection. Finally this Chapter considers the nature of regulation and discusses some regulatory techniques employed in protecting investors in the OTC derivatives market.

4.2 An overview of the OTC regulatory framework

The current regulation for the OTC markets comprises:

- Chapters 7 and 8 of the Corporations Law which regulates securities and futures contracts;
- general government legislation which may have an impact on financial derivatives; and
- prudential regulation imposed by regulatory agencies on one or both parties to a derivatives contract.

Broadly, the system of regulation of OTC derivatives is drawn from these three groups of regulation. The first comprises the main source of direct regulation of derivatives, both on exchange and OTC. The second group comprises of legislation which is not directed at any sector of the capital market but is of general application. Examples within this group are the Crimes Acts of the States and the *Trade Practices Act 1974* (Cth). The *Trade Practices Act 1974* is aimed at discouraging unconscionable, deceptive and misleading conduct in the business community whilst the Crimes Acts of individual States are directed at discouraging fraud and other criminal conduct in the wider community, including those trading in derivatives. As consumer and criminal legislation has an impact on participants in the OTC market, this second group has been included as part of the regulatory framework. The third group, namely prudential regulation, is industry based in that it applies only to members of a particular industry. For example, all banks are subject to prudential supervision by the Reserve Bank of Australia. This functional method of regulation may be justified on the grounds that it allows regulators to develop special expertise in supervising particular industries.[5] However, the Wallis Committee, in its Final Report, recommended[6] a single Commonwealth prudential regulator be established under the name of Australian Prudential Regulation Commission (APRC) to regulate the financial system. If the recommendation is adopted, the supervisory system will see fundamental reallocation of functions to regulatory agencies. The recommendations of the Wallis Committee will be discussed in greater detail in Chapter 8.

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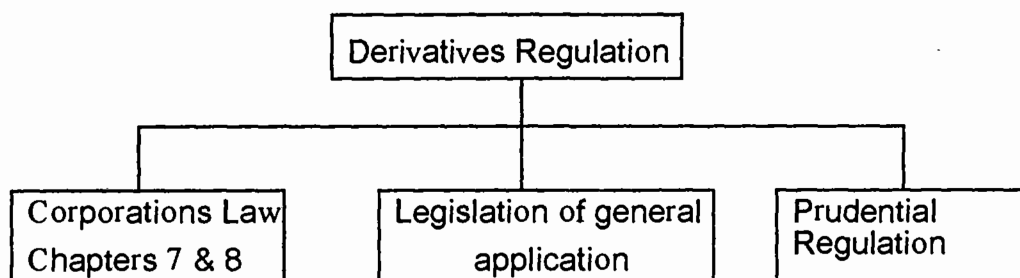
[5] Garten, HA, *Why Bank Regulation Failed - Designing a Bank Regulatory Strategy for the 1990s*, Quorum Books, New York, 1991, 164.
[6] Financial System Inquiry, Financial System Inquiry Final Report, Australian Government Publishing Service, March 1997 (Wallis Final Report), Recommendation 31.

Figure 3 below shows the structure of the existing regulatory scheme.

Figure 3

The Regulatory Framework for OTC Derivatives



4.2.1 *Corporations Law*

Chapters 7 and 8 of the Corporations Law are product-based regulation in that these two Chapters are concerned with the regulation of products. The Corporations Law regime applies only if the product is a "securities" or a "futures contract" within the meaning ascribed to these terms in the Corporations Law. Product-based regulation refers to regulation which is promulgated for specific products. Under the current regime, derivatives falling outside the statutory definitions of "securities" or "futures contracts" in sections 92, 92A, 72 and 72A are not governed by the Corporations Law. Although they apply to all exchange-traded products, and are aimed mainly at those products, the regimes in Chapters 7 and 8 are also relevant to some OTC derivatives. The Australian Securities Commission (ASC) administers the Corporations Law by virtue of subsection 1(1) of the Australian Securities Commission Act, 1989.

The extent of the application of Chapters 7 and 8 to OTC derivatives instruments is discussed in Chapter 5 of this thesis.

4.2.2 *General regulation*

Consumer legislation[7] which is intended to protect retail investors or consumers and the criminal legislation which proscribes fraud and deceptive conduct has relevance when considering the regulation of OTC derivatives. More specifically, the legislation referred to includes:

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[7] This comprises both Commonwealth and State enactments.

- the *Trade Practices Act 1974* (Cth) which legislates against a variety of malpractices and undesirable conduct such as restrictive trade practices, unconscionable conduct, misleading or deceptive conduct and misrepresentations;
- the consumer legislation of the States, primarily the Fair Trading Acts, which contain numerous provisions that are almost in pari materia with the *Trade Practices Act 1974* (Cth); and
- the criminal legislation of the States which, among other things, legislates against fraudulent conduct.

Pursuant to the *Trade Practices Act 1974* an intermediary could be liable for misleading or deceptive conduct in providing erroneous information to clients about the nature of a derivatives product. Similarly if the offensive conduct in a derivatives transaction is criminal in nature, the allegedly offending party could be charged under the criminal legislation of the State in which the crime ia alleged to have taken place. These laws are, however, general laws and are not tailored for the OTC derivatives markets. The complexity of some OTC instruments may create difficulty for the regulator in establishing the standard of liability required in a criminal prosecution to secure a conviction, that is, beyond reasonable doubt.

The Australian Competition and Consumer Commission has responsibility for ensuring compliance with the *Trade Practices Act 1974* (Cth) while the Director of Public Prosecution of each State or Territory prosecutes fraud and other criminal activities.

4.2.3 Prudential regulation

Apart from the above, there are other sources of control which are less direct, and these take the form of prudential controls exercised by national regulators such as the Reserve Bank of Australia and the Insurance and Superannuation Commission over their regulatees, that is, the banks and insurance companies or superannuation funds whom they regulate.

At the State level, State Supervisory Authorities working in association with the Australian Financial Institutions Commission[8] and in accordance with the prudential standards set by that Commission, regulate building societies, credit unions and other State-based financial institutions.[9]

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[8] The Commission was established by the *Australian Financial Institutions Commission Act 1992* (Queensland).

[9] Wallis Final Report, note 6, 188.

It has been mentioned in Chapter 1 that the central theme of this thesis is an evaluation of the existing regulatory framework to determine whether it has the capacity to provide adequate protection to retail investors dealing in the OTC markets. The capacity of the regulatory framework to control malpractices in the OTC markets is important from the perspective of investor protection. If protective mechanisms are not in place or are inadequate, unsophisticated investors would be exposed to fraudulent or manipulative practices and consequently could incur financial losses arising from such activities. It is therefore proposed that a detailed analysis of the regulatory structure will be undertaken in the next three chapters. Before commencing on the analysis, it would be appropriate to discuss the nature of regulation.

4.3 Nature of regulation

It will be demonstrated in the next three chapters that gaps exist in the regulatory structure. Some of these gaps are dangerous to investors and if unattended to, could lead ultimately to a loss of investor confidence in the markets. A regulatory environment beset by legal and regulatory uncertainties and regulatory gaps - which could expose derivatives participants to a higher degree of credit and market risks - would have ingredients which could increase the threat of a systemic crisis.

In order better to appreciate the effect which gaps may have on investor protection, it is important to bear in mind the nature of regulations - their goals, justification and regulatory techniques employed to achieve this end. For this reason, this part of the Chapter is devoted to a discussion of the nature of regulation in so far as relevant to OTC markets.

4.3.1 Meaning of Terms

Before discussing the main theoretical issues, it is useful to review the meanings and application of some key terms used in this thesis. A consideration of these terms will provide a better understanding of the theories on derivatives regulation.

4.3.1.1 Regulation

The term "regulation" has ascribed to it a number of meanings. The Australian Concise Oxford Dictionary[10] interprets this expression to mean "the act or an instance of regulating; the process of being regulated; a prescribed rule; an authoritative direction;" and the root word "regulate" is described as "control by rule; subject to restrictions; adapt to requirements". Such a wide definition would fit a variety of situations in the regulatory context. The prescription by the government in legislation

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[10] Hughes, JM et al. (ed.) *The Australian Concise Oxford Dictionary* Oxford University Press, Melbourne, 1993.

commanding certain behaviour would be "regulation" as would any regulation made under legislative enactments, for example, the ASC Regulations (made under the ASC Law). Equally, the description would fit those less formal Business Rules of the exchanges or clearing houses as well as voluntary codes of conduct. Often, however, a distinction is made between "government" regulation which has the force of law and "market" regulation in respect of which compliance is voluntary in the sense that a party may opt out simply by withdrawing from membership to that private arrangement. Despite such a wide range of meanings, there are essentially three main groups of regulations:

(a) government regulation which includes legislation and the regulations made under them;
(b) market regulation consisting mainly of voluntary codes of conduct; and
(c) hybrid regulation which possesses the characteristics of both government regulation and market regulation.

These forms of regulation are dealt with below.

(a) Government regulation

Government regulation comprises enactments as well as regulations made under such enactments, which have been promulgated by the State over the years and which have not been repealed. Regulation made by the government is frequently characterised by its:

- directive function whereby the State prescribes rules which it "commands" the public to obey, and prescribes punishment or sanctions for those who fail to comply;
- public law nature in that its application cannot be excluded by contract; and
- centrality in that the entire process of formulation of the rules and its enforcement is in the hands of the State.[11]

Ogus[12] calls this the "collectivist" system of regulation since the regulation is made to meet collective goals of the public.[13] It is, however, more commonly referred to as "command and control" regulation.

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[11] Ogus, A, *Regulation: Legal Form and Economic Theory,* Clarendon Press, Oxford, 1994, 2.
[12] Ogus, A, note 11, 1.
[13] Ogus, A, note 11, 2

(b) Market regulation

The gaps in the Corporations Law do not automatically lead to the conclusion that more government regulation is needed. In fact proponents of market regulation would argue against any further government intervention on the basis that the market system of regulation is efficient and adequate to discipline market players.

The market model of regulation exhibits distinctive characteristics, among which are that:

- it has a facilitative function with rules aimed at promoting the welfare of members. These rules typically confer rights and privileges while, at the same time, impose obligations under a private arrangement agreed among members;
- the enforcement of obligations are a matter for the members; and
- being private, the rules may be easily varied or amended by agreement among the members.[14]

The distinguishing feature of market regulation is that compliance is voluntary and a party may opt out simply by withdrawing from membership to that private arrangement.

Market regulation, although premised on the notion of caveat emptor and freedom to contract, does not mean freedom from government regulation. The regulatees remain subject to certain basic restraints such as criminal and tortious laws and the system is underpinned by the legal system of the country.[15]

(c) Hybrid regulation

The "Business Rules" of exchanges and clearing houses belong to this category as these rules are formulated by the members but are subject to some governmental control.

The "Business Rules" of the exchanges[16] or of a clearing house of a futures exchange,[17] or of a futures associations[18] generally refer to the constitutions of these organisations or rules, regulation and by-laws made by them. Although the Business Rules are drawn up by members of these organisations, they are subject to government control. Both Chapter 7 (in section 774) and Chapter 8 (in section 1136) of the

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[14] Ogus, A, note 11, 2.
[15] Ogus, A, note 11, 1.
[16] Section 761 (definition ofi "business rules") and section 774.
[17] Section 1122 (futures exchange).
[18] Section 1120 (futures association).

Corporations Law make provision for all amendments to be notified to the ASC which is required to forward a copy of it to the Minister. The Minister is empowered, in relation to securities exchange, under subsection 774(6), or in relation to futures exchange, clearing house and association under subsection 1136(5), to veto any amendment. In addition, business rules have the force of law in that the Court are empowered to order compliance with them.[19]

4.3.1.2 *Investors*

The term "investors" is used in this thesis to denote a wide range of persons including not only end users of derivatives products, but also other stakeholders such as bank depositors, insurance policy holders, members of mutual and superannuation funds, and shareholders of companies which trade in derivatives. In the context of regulation, a distinction is drawn between sophisticated and unsophisticated investors.

(a) Sophisticated investors

The term "sophisticated investors" refers to those who possess a sound knowledge of derivatives or are in a position to hire competent advice. This group of investors would be capable of entering into derivatives contract on more or less an equal footing with intermediaries.

(b) Unsophisticated investors

The expression "unsophisticated investors" or "retail" investors is used in this thesis to mean the group of persons, mainly end users in the retail market, whom the press sometimes refer to as the "mums and dads". The group comprises those who are generally ignorant of the complexities of derivatives trading or those who, although knowledgeable, require protection from their own foolhardiness in entering into imprudent leverage contracts.

4.3.2 Goals of derivatives regulation

As the historical discussion of legislation in Chapter 1 showed, the goals or objectives of futures and securities regulation centre on the protection of users of the financial markets and on the maintenance of a fair and cost effective market.[20] These goals, which were originally in the *National Companies and Securities Commission Act 1979* (Cth) are now contained in section 1 of the *Australian Securities Commission Act 1989* (Cth). That they are still regarded as the primary goals of regulation is clear

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[19] Section 777 (in relation to securities exchange), section 1140 (in relation to futures exchange, clearing house and association).

[20] See also Baxt, R, et al., *Stock Markets and the Securities Industry - Law and Practice*, Butterworths, Sydney, 1988., 20.

from the following statement in the Final Report of the Wallis Committee released in April 1997:

> "(S)pecialised regulation is required to ensure that the market participants act with integrity and that consumers are protected."[21]

Investor protection regulation refers to the forms of regulation made for ensuring that retail investors have adequate information and are treated fairly.[22] Markets which are unregulated may be exposed to a number of risks (such as manipulative conduct by market participants, fraud, financial collapse, credit risk, market risks and legal risks) which could bring financial ruin to investors and if carried out on a large scale, could bring about a systemic crisis and create havoc in the entire national or even global financial system. Regulation is seen to be an important tool in achieving investor protection and stability for the financial system and consequently investor confidence.

Investor confidence in the solvency of the financial institutions and its stability is crucial to an effective and efficient market.[23] This view, which was expressed in 1981 in the final report of the Australian Financial System Inquiry, was echoed recently by Philip Wood, an English author, who argued that government intervention is inevitable where the activity has a high risk of abuse.[24]

The other key objective of derivatives regulation, that of maintaining a fair market, is characterised by measures aimed at promoting its integrity and encouraging observance by financial intermediaries of their fiduciary duties towards their customers.[25] A fair market has been defined as a market where:

> "at the minimum, investors are: protected from fraudulent practices (such as insider trading and front-running); accorded fiduciary rights when their intermediaries are acting in a fiduciary capacity (such as the right to obtain best execution and the right not to be disadvantaged by acts of the fiduciary) and, finally, treated generally in a just and equitable manner by market professionals

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[21] Wallis Final Report, note 6, 175.
[22] Wallis Final Report, note 6, 187.
[23] Australian Financial System Inquiry, 'Final Report', Australian Government Publishing Service, Canberra, September 1981, 285.
[24] Wood, PR, *International Loans, Bonds and Securities Regulation*, Sweet & Maxwell, London, 1995, 252.
[25] International Organisation of Securities Commission, 'Transparency On Secondary Markets - A Synthesis of the IOSCO Debate', Il Sole 24 Ore Societa Editoriale Media Economici Seme SpA - Division Libri, Milano, 1993, 13.

in accordance with rules of business conduct (an example of these rules is the provision of price and time priority for limit orders in auction markets)."[26]

These goals - investor protection and promoting market integrity - are closely linked. Promotion of a fair and efficient market is arguably a means of investor protection. This would perhaps explain why the same regulatory tools, namely disclosure and good conduct regulation, are used to achieve these goals.[27]

4.3.3 Justification for regulation

It is a widely-held view, especially by economists, that a competitive market should generally be unregulated. This view is founded on the belief that a market system is most efficient if there is a minimum of regulation and government intervention.[28] The absence or lack of regulations has often been credited with a market's greater efficiency and innovation. Smith and Walter (1990) persuasively argued that deregulated markets and markets which are beyond the reach of national authorities are highly efficient and developed while the performance of regulated markets has been so unimpressive that they are in danger of being relegated to "financial backwaters".[29] Similar views were expressed by Steven Breyer who asserted that the rationale for an unregulated market is founded on basic societal values which hold that there should be freedom of individual action and a minimal of government interference.[30]

Successive parliamentary committees inquiring into the financial system have largely subscribed to this philosophy. The Campbell Committee in its report opined:[31]

> "Market practices should be as free of regulation as is consistent with the objective of maintaining investor confidence. So long as they are given the information necessary to make soundly based investment decisions, investors should be free to invest according to their risk/return preferences."

In March 1997, the Wallis Committee reaffirmed this view when it said:

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[26] International Organisation of Securities Commission, note 25, 13.
[27] Wallis Final Report, note 6, 187.
[28] Australian Financial System Inquiry Final Report, note 23, paragraph 1.1.
[29] Smith, R C & Walter, I, *Global Financial Services: Strategies For Building Competitive Strengths In International Commercial and Investment Banking*, Harper Business, New York, 1990, 700.
[30] Breyer, S, 'Analyzing Regulatory Failure: Mismatches, Less Restrictive Alternatives, and Reform', in Ogus, AI, & Veljanovski, CG, *Readings in the Economic of Law and Regulation*, Clarendon Press, Oxford, 1984, 234.
[31] Australian Financial System Inquiry Final Report, note 23, paragraph 21.26.

"Free and competitive markets can produce an efficient allocation of resources and provide a strong foundation for economic growth and development. ...The general case for regulation is founded on market failure... Market failure is a necessary but not sufficient condition for government intervention."

There is a general perception that regulation imposes costs on both the regulator (because the regulator must devote time, human resources and money to monitoring compliance with and enforcing regulation) and the regulatee (because it is required to consume resources to comply).[32] Prima facie, therefore, regulation is expensive and from an economic perspective, justifiable only if there are good grounds for it. One such ground is the prevention of "market failure". The term "refers to situations in which a market fails to allocate resources efficiently because of the existence of public goods, market power, externalities or information costs."[33]

Two likely sources of market failure in the OTC markets are the risk of losses to the general public due to a systemic crisis and the problem of information asymmetry particularly on credit standing of the counterparty:[34]

Given that a prerequisite of a free market economy is non governmental intervention, the imposition of regulations is justifiable only if they can be shown to be essential to achieving an important public objective which would not be possible in an unregulated market,[35] or if can be shown that without regulation, there will be market failure.[36]

In the context of the capital markets, a distinction may be made between sophisticated investors and those unsophisticated investors trading at the retail end of the market. It is well recognised that sophisticated investors are less likely to be subjected to abusive market practices given that they have the means, that is, the financial resources and the expert knowledge or the access thereto, to make a fair bargain. This group needs no special legislative protection. On the other hand, retail investors would be vulnerable since they may be either too poor to seek professional advice or too ignorant to ensure that they have obtained a fair deal. Also some of them may be too impulsive or too greedy to make a rational judgement[37] although arguably, impulsiveness and greed are not traits which are confined solely to retail investors. Cases such as AWA and

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[32] Albrecht, WP, 'Regulation of Exchange-Traded and OTC Derivatives: The Need For a Comparative Institution Approach', *The Journal of Corporation Law*, Fall, 1995, 111 at 116.
[33] Albrecht, WP, note 32, 117.
[34] These failures were identified in the Wallis Final Report in relation to financial markets but, it is submitted, is applicable also to the OTC derivatives market: Wallis Final Report, note 6, 189.
[35] Breyer, S, note 30, 234.
[36] Wallis Final Report, note 6, 175.
[37] Wood, PR, note 24, 252.

Orange County are constant reminders that large corporations are just as likely to succumb to the temptation of speculating for high returns.

Because unsophisticated investors may lose their life's savings if they gamble on derivatives contracts, the public interest must be considered. To minimise undesirable social consequences such as bankruptcies, government intervention may be necessary to save small investors from their own folly. Regulation in these circumstances is acceptable.

There are a number of other factors, arising from the peculiarities of the OTC market, which justify specialised regulation to ensure the protection of unsophisticated investors trading off-exchange. Some OTC products are complex and may not be easily understood by the unsophisticated or retail investors. Failure to fully appreciate the nature of a product could lead to wrong investment decisions and consequently economic loss. These retail investors are handicapped by their lack of knowledge and may be said to be in a position of unequal bargaining power. Government intervention may be required to restore the balance so that the parties affected are placed on an equal footing.[38] Such a balance is important because the efficient functioning of a free market is premised on the assumption that the bargaining power is evenly distributed.

Second, because derivatives contracts, including those traded in the OTC market, are intangible and invisible, there are greater opportunities for abuse and other undesirable practices in the market place.[39] As Philip Wood pointed out, property such as shares, "which represents a share in a bundle of assets ... is ... more difficult to evaluate and the investor is more exposed to imprudent investments or, in extreme cases, to sharp practice or deceit."[40] His comments are equally valid for financial derivatives some of which are extremely complex. If those abuses against investors, which were carried out on a wide scale in the capital markets in the 1960s[41] and the 1980s[42] are not to be allowed to recur, regulation is necessary.

Third, as explained in Chapter 3 of this thesis, an investor in the OTC market is exposed to a greater degree of credit risk than an investor in an on-exchange market. OTC transactions are made between two parties, each of whom is exposed to the risk

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38 Breyer, S. note 30, 234.
39 Wood, PR, note 24, 252. Wood referred to securities but it would be equally true for derivatives.
40 Wood, PR, note 24, 252.
41 For a discussion of some of these early malpractices, see Baxt, R, et al., note 20; Senate Select Committee on Securities and Exchange (Rae Committee), *Australian Securities Markets and their Regulation*, Volume 1 Report, Australian Government Publishing Service, Canberra, 1974.
42 Tomasic, R & Bottomley, S, *Directing the Top 500*, Allen & Unwin, Singapore, 1993.

that its counterparty may default while a party to an on-exchange contract is largely insulated from credit risk by the protective mechanism in the exchange structure. Exposure to risk is greater as OTC contracts are generally entered into for a considerably longer period than exchange-traded derivatives contracts.

Fourth, the operational risk for off-exchange transactions is higher for investors in the OTC markets, principally because most individual investors, particularly those who are trading at retail level, are unlikely to have access to comprehensive risk management systems, such as those owned by the clearing houses.

It is submitted that there is ample justification for regulating the OTC markets. For the reasons given, it is to be concluded that a successful regulatory model for the OTC derivatives market cannot be constructed purely from the economists' perspective alone. Public interest factors cannot be ignored and whatever the merits of the economists' arguments for a regulation free environment, regulation is justified to deter abusive practices so that those less able to protect themselves are afforded government protection. This is particularly true for Australia with an ageing population[43] dependent on savings and superannuation accumulated over a lifetime to support a reasonable standard of living.

Having come to the conclusion that regulatory intrusion in the OTC markets is justifiable, the next issue to consider is how and in what form the regulation should be made. Also to be considered are the actors to whom the regulation is directed. It is noted that on the supply side of the derivatives trade are intermediaries (which include brokers, advisers and market makers such as banks and insurance companies) and on the demand side are the end users. Clearly, strategies aimed at protecting the small investors should be focused on the derivatives suppliers. It is envisaged that such strategies should take the form of conduct regulation (such as criminal sanctions against undesirable conduct)[44] and disclosure regulation by compelling adequate disclosure by suppliers as well as by proscribing false and misleading statements.[45] Other investor protection safeguards which may be imposed on suppliers of the market are licensing (to ensure that only qualified persons are allowed to deal with retail investors), suitability rules, and more generally, prudential regulation. These legislative techniques are discussed below.

[43] Wallis Final Report, note 6, 90-91.
[44] Wallis Final Report, note 6, 186.
[45] Wallis Final Report, note 6, 186.

4.3.4 Regulatory tools for investor protection

The question as to how and in what form the regulation should be made could only be answered by examining the various tools identified in this section of the Chapter and assessing them in terms of their usefulness in delivering protection to investors in the OTC markets.

4.3.4.1 Disclosure

Disclosure is often used as a regulatory tool to achieve fair outcomes for investors. It protects investors in several ways.

First, disclosure could be used to ensure that investors are provided with accurate relevant information which enables them to make informed investment decisions.[46] Disclosure has been employed, for example, in penny stock legislation in the United States to protect small investors. Penny stock is referred to here because these stocks and OTC derivatives share common characteristics - both are speculative by nature.[47] In order to protect investors and to maintain fair and orderly markets, the Securities Enforcement and Penny Stock Reform Act of 1990 (US) makes it unlawful to violate any of the disclosure requirements in that Act as well as any rules "reasonably designed to prevent fraudulent, deceptive, or manipulative acts and practices with respect to penny stocks."[48] That Act imposes substantive disclosure upon broker-dealers by requiring them to make pre-trade disclosure with respect to the liquidity and pricing of each penny stock purchased. The broker-dealer must also provide customer with monthly statements indicating the value of the account's pennystock holdings.

Second, pre-trade disclosure or transparency is said to provide all investors with equal opportunity to gain access to real time information and thereby ensures efficient pricing of derivatives instruments and efficient allocation of capital.[49]

Third, disclosure ensures that market participants are on an equal footing when their orders are executed. Information on product characteristics, risk profile and functions put investors in the best position not only to select products relevant to their needs,[50] but the best time and place to trade.[51]

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[46] Gordon, JN & Kornhauser, LA, 'Efficient Markets, Costly Information, and Securities Research', 60 *New York University Law Review*, 1985, 761.
[47] Hazen, TL, 'Rational Investments, Speculation, or Gambling? Derivative Securities and Financial Futures and their Effect on the Underlying Capital Markets", *86 Northwestern University Law Review*, 1992, 987 at 1034.
[48] See Hazen, TL, note 47, 1034.
[49] International Organisation of Securities Commission, note 25, 14.
[50] Wang, AQ, 'Banks' OTC Derivatives Trading: Asymmetric Risk Information and Legal Solutions',

Fourth, disclosure of pertinent information about a derivatives dealer or a derivatives product would enhance customer awareness and minimise the misconception that an investment product purchased, say, on bank premises was the same as an insured deposit.[52]

However, it has been argued that the requirement for transparency, whilst it has the benefits enumerated above, may be detrimental to investor interests in some aspects. An obvious disadvantage is cost to the investors since the provision of information, like other commodities, involves costs.[53] The issue of costs has been discussed above. Also, it has been argued that real time[54] disclosure of information which is commercially sensitive could damage the interest of dealers who buy or sell a block as a principal. Since a dealer who bought a block would invariably carve it up for sale to two or more buyers, real time disclosure in these circumstances would provide the other players in the market with information which would suggest the size of the dealer's position. Such information enables the other participants to trade against that dealer.[55] Third, disclosure may not be sufficient to prevent market failure because in respect of many of the OTC derivatives, investors do not have the knowledge or expertise to make informed decisions despite being supplied with information.[56]

Whilst the objections to regulation may have their merits, it is submitted that disclosure is too important to ignore. It is a means by which retailed investors are ensured an adequate supply of information to put them in a position to understand the types of risks associated with derivatives. Even at common law, a supplier may be liable in tort to the end user for say, negligent misstatement.[57] The lack of information which creates an unconscionable bargaining advantage could also render a contract voidable[58] or could make the supplier liable under the *Trade Practices Act 1974* (Cth) for misleading and deceptive conduct. As the application of common law principles

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a paper submitted for examination in the Research Unit, Faculty of Law, Australian National University, 1995, unpublished dissertation, 20.

51 International Organisation of Securities Commission, note 25, 15.

52 Testimony of Governor Edward W. Kelley, Jr. on behalf of the Federal Reserve Board, before the Subcommittee on Capital Markets, Securities and Government Sponsored Enterprises Committee on Banking and Financial Services, U.S. House of Representatives Testimony on June 26, 1996.

53 International Organisation of Securities Commission, note 25, 60; Wang, AQ, note 50, 19.

54 This generally means "prompt" whereas in the US it means 90 seconds from a trade: International Organisation of Securities Commission, note 25, 24.

55 International Organisation of Securities Commission, note 25, 43-44.

56 Wallis Final Report, note 6, 190.

57 Companies & Securities Advisory Committee, 'Regulation of the OTC Derivatives Market, Discussion Paper', 1995 (CASAC OTC DP), 29.

58 Overdahl, J & Schachter, B, 'Derivatives Regulation and Financial Management: Lessons From Gibson Greetings', *Financial Management*, Vol 24 No 1, Spring 1995, 68.

and those in general consumer legislation is uncertain and may not create a clear duty on the part of the suppliers to provide relevant and full information,[59] statutory disclosure requirements will help to ensure that retailed investors are protected by imposing a clear standard of liability on suppliers.

4.3.4.2 Licensing

The purposes of licensing are:[60]

1. to avoid overcrowding
2. to limit licensing to those who are reputable and have the necessary expertise and financial backing;
3. to extend the range, sophistication and variety of financial services and intermediaries

For the OTC markets licensing is an effective regulatory tool as it enhances investor protection, principally by providing a framework for regulatory supervision of those who are minded to carry on business in the OTC markets as a broker, dealer or other intermediary roles. Derivatives are complex instruments but by means of licensing, regulators would be in a position to weed out incompetent or undesirable dealers, that is, those who are dishonest, are not adequately resourced to conduct the business of an intermediary and those who lack the necessary qualifications and experience. Licensing provides a regulator with the opportunity of imposing specific terms or restrictions to reflect the experience and expertise of licensees,[61] such as requiring licensees to take and pass a securities industry professional qualification examination before being given a licence to sell derivatives to retail customers. This will ensure that dealers are appropriately trained and educated and would provide competent advice to their retail clients.[62]

The potential for conflict of interest is strong in the OTC markets. The adviser recommending that a client buys a particular derivatives product may also be the seller of that product.[63] Further, the complexity of OTC instruments and the inherent risks

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[59] This will be discussed further in Chapter 6; see also CASAC OTC DP, note 57, 29.

[60] These criteria were used by the Singapore Government in relation to the selection of off-shore banks. See Australian Financial System Inquiry, *Commissioned Studies and Selected Papers Part 2 Macroeconomic Policy: External Policy,* Australian Government Publishing Service, Canberra, 1982, 459.

[61] CASAC OTC DP, note 57, 24.

[62] The United States is moving towards requiring bank employees to take and pass a securities industry professional qualification examination before beginning to sell securities to retail customers: See the testimony of Governor Edward W. Kelley, Jr. note 52.

[63] Australian Securities Commission, 'Report On Over-The-Counter Derivatives Markets', 1994 (ASC Final Report), paragraphs 244 and 245.

which the members of the public face in trading in these instruments, makes licensing an imperative in the law reform agenda.

4.3.4.3 Prudential requirements

Prudential regulation is directed at achieving two objectives; the primary goal of protecting depositors and other investors and the wider objective of promoting stability in the financial system.[64] The broad approach taken by regulators to prudential regulation is that the basic responsibility for good corporate governance practices rest with the boards and management of the companies.[65] The primary goal of prudential regulation is to reduce systemic risk in the financial system and to protect investors.[66] Towards this end, prudential regulations are directed at ensuring that the regulatees adhere to prudential standards set by their regulator. Typically these regulations take the form of capital adequacy requirements, investment guidelines or restrictions, solvency and liquidity requirements.[67] Prudential regulation has been employed for centuries and has proved to be a useful regulatory tool in maintaining systemic stability. Such stability enhances investor protection.

4.3.4.4 Prohibition of undesirable market practices

One regulatory instrument of universal application used to protect investors is the prohibition of manipulative and fraudulent practices such as insider trading and front-running.[68] Some of the abuses in the OTC markets are not common crimes nor are they typical types of consumer "offences" but they occur only in the futures and securities markets. As such, they are outside the reach of the general criminal and consumer laws. These unsavoury practices require specially enacted provisions to keep them in check. Accordingly, the securities and futures regimes of most jurisdictions incorporate offence provisions proscribing such conduct. The prohibition of undesirable practices is necessary to maintain investor confidence in the integrity, fairness, and efficiency of securities and futures markets.

4.3.4.5 Suitability rule

Suitability requirements refer to the obligation imposed on suppliers, particularly dealers, to inquire about a client's financial situation, investment objectives and particular needs. These requirements are sometimes known as "know your client"

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[64] Currie, C, 'The Effect of Derivatives On Financial System: Stability and Efficiency - Implications For Prudential Supervision', University of Technology, Sydney, 1993, paragraph 3.0.
[65] Financial System Inquiry, Discussion Paper, Australian Government Publishing Service, November 1996 (Wallis DP), 192.
[66] Wallis DP, note 65, 279.
[67] Wallis DP, note 65, 101.
[68] International Organisation of Securities Commission, note 25, 13.

rules. The rationale for them is that by assisting the clients to make the right decision, the level of default among the participants may be reduced and consequently the stability of the markets is enhanced.[69]

The regime in Chapter 7 of the Corporations Law imposes an obligation on securities advisers to ensure that it has a reasonable basis to make a recommendation to its clients in relation to a securities transaction.[70] The suitability rule extends to a requirement that the subject matter of the recommendation be investigated and considered.

The futures regime in Chapter 8 does not have a similar suitability requirement. Although an attempt was made in the First Exposure Draft of the Futures Industry Bill 1985 to impose on the futures broker an obligation to "make the prescribed inquiries" -including information to enable the broker to determine the client's credit worthiness and suitability for dealing in futures contracts - this proposal was dropped at the Second Exposure Draft stage as it was considered too onerous and impractical.[71] The Sydney Futures Exchange, however, does have a suitability requirement under By-Law G.32(a)(iii) for Managed Discretionary Account.[72] Whether a suitability requirement should be imposed for the OTC derivatives market is a difficult issue. Although such a rule has merit from the perspective of investor protection, it may not be practical. A broker often needs to execute an order with the minimum delay in order to obtain the best price for its client and the time taken to make the prescribed inquiries may be counter productive.[73]

4.4 Conclusion

As mentioned above, regulations promulgated for the securities and futures markets have focused on investor protection[74] with regulation being enacted for the protection of those who are less capable of protecting themselves. For this reason, the regime in the Corporations Law shows a marked preference for regulating on exchange contracts, as evidenced by section 1123. The rationale for this is clear: members of the general public comprising unsophisticated investors may be involved, and they must be protected.

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[69] CASAC OTC DP, note 57, 56.
[70] Section 851 of the Corporations Law.
[71] Companies and Securities Advisory Committee, 'Law of Derivatives: An International Comparison', 1995 (CASAC International Comparison), 43.
[72] CASAC International Comparison, note 71, 43.
[73] CASAC International Comparison, note 71, 43, f/n 140.
[74] Hazen, TL, note 47, 1013.

The on exchange rule is to ensure that the derivatives transactions are well regulated by Chapters 7 and 8 of the Corporations Law and the Business Rules of the clearing houses and the exchanges. The exchange markets have in place mechanisms which offer significant protection to investors. Counterparty risk in exchange traded futures contracts are minimised because the business rules of the clearing house require the clearing house to be a counterparty to each contract. A well conducted clearing house with the added assurance of the guarantee of its individual members, will reduce credit risk significantly. Market risk is reduced by the requirement that the contracts be marked to market[75] and that where a contract is out of the money, the investor is obliged to provide adequate margin to top up its deposit. In relation to an exchange traded contract, therefore, both credit risk and market risk are controlled and minimised. As the next Chapter will show, many of the OTC products are not regulated by the Corporations Law regime and investors trading in such contracts will not have the benefit of the statutory protection afforded by the Corporations Law.

However, it is expected that in the years ahead, small investors will also be more visible in the OTC markets. Already OTC derivatives are used by retail investors. For example, home mortgage products often contain embedded OTC derivatives. The home loan may limit interest payment for a fixed term, typically of one, two, three or five years, which in derivatives term is called a cap or it may allow prepayment without a penalty which gives the bank customer an option. Both caps and options are OTC derivatives product.

A discernible trend in society is the changing needs of ordinary unsophisticated investors being brought about by an ageing population, reduced job security, early retirement, increasing exposures to the financial system and increasing value awareness.[76] These factors create a demand for OTC products which will enable these retail investors to better manage their financial assets. It is expected that in response to such demands, other retail OTC products will be made available to the general public in the not too distant future.

Given that retail investors are likely to be active in the OTC market, a key question to be considered is the extent to which the OTC market should emulate and adopt the regulation currently existing in the exchange traded markets. Arguments against more regulation in the OTC market include the propositions that regulation inhibits product innovation and increases the cost of compliance. While there are many advantages to free and unfettered markets, it is fairly well-known that free markets attract problems

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[75] Valued at current market prices.
[76] Wallis Final Report, note 6, 89.

such as the possibility of anti-competitive monopolies, fraud or insider trading, systemic crises due to illiquidity or insolvency of individual financial institutions.[77] As seen earlier in this Chapter, there are ample reasons for regulation.

It is submitted that the rationale for regulating derivatives in the exchange traded market is equally valid in relation to the OTC derivatives market. In both markets, retail investors are or may be involved and they must be given the same protection, whichever market they trade in. The challenge is to achieve the primary regulatory goal of protecting investors in the most efficient and effective way possible. This calls for an examination of the regulatory structure to identify the gaps in investor protection which exist therein. The process is spread out over three chapters, with the next chapter being devoted to an identification of the gaps in the Corporations Law regime.

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[77] Moskow, MH, 'Derivatives and Public Policy', speech given by Michael H. Moskow, President, Federal Reserve Bank of Chicago to a conference sponsored by the Federal Reserve Bank of Chicago, Chicago, IL, June 6, 1996.

CHAPTER 5

IDENTIFYING THE GAPS IN CHAPTERS 7 AND 8 OF THE CORPORATIONS LAW

5.1 Introduction

This Chapter constitutes the first stage of the analysis of the regulatory framework governing financial derivatives outlined in the methodology in Chapter 2. Following on from the discussion in Chapter 3 of this thesis of a number of risks associated with derivatives, this Chapter examines the deficiencies in the regulatory framework as set out in the Corporations Law, principally in Chapters 7 and 8 and argues that those risks are exacerbated by regulatory flaws. The analysis of the regulatory gaps is carried out with reference to the two groups of OTC contracts below.

5.1.1 *OTC derivatives contracts*

In the context of derivatives regulation, OTC derivatives may be divided into two broad categories:

(1) Contracts which are subject to the provisions of the Corporations Law but traded off-market. Examples of these contracts include the following:

 (a) a "futures contract" within one of the four contracts listed in but not excluded under paragraph 72(1)(d) and exempted under section 1127;

 (b) a "futures contract" or "securities" contract traded among members of corporate groups. Such a contract requires exemption under section 1127 (if a futures contract) or under section 771 (if a securities contract);

 (c) any OTC "futures contract", other than intra group transactions referred to in paragraph (b) above, which is exempted under section 1127; and

 (d) any derivatives of securities traded on a stock market which is declared by the Minister to be an exempt stock market under section 771, other than intra group transactions referred to in paragraph (b) above.[1]

(2) Contracts which are not regulated by the Corporations Law because they are not securities or futures contracts. Examples of this group include:

 (a) OTC derivatives which cannot be classified as "securities" or "futures contracts" particularly options, such as OTC equity options,[2] OTC

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[1] Exemptions made under sections 1127 and 771 of the Corporations Law are for an entire futures or securities market.

options over a share index,[3] OTC compulsory cash settled options[4] and OTC commodity options;[5]

(b) a contract excluded from the definition of "futures contract" by virtue of paragraph 72(1)(d) of the Corporations Law; and

(c) a contract prescribed to be excluded by virtue of paragraph 72(1)(e) of the Corporations Law.

The Corporations Law regime, which regulates the group of derivatives in (1) above, will be examined in the following paragraph 5.2 of this Chapter. The goal is twofold: to map the extent of the application of the Corporations Law to OTC derivatives and to identify the deficiencies within the regulatory structure in the context of the broader objective of determining if the current regime, as it stands, has the capacity to protect investors adequately. This will be followed by a discussion of issues concerning unregulated derivatives, to which the category in (2) relates.

5.2 OTC derivatives contracts regulated by the Corporations Law and regulatory gaps

OTC derivatives are regulated under the Corporations Law if they are "securities" or "futures contracts" as defined in section 92 or section 72 respectively or if they are prescribed by regulation made under section 92A or section 72A to be subject to the Corporations Law. Those which are "securities" and those which are prescribed by regulation,[6] are subject to the regime in Chapter 7. Similarly, only those which are "futures contracts" or are prescribed by regulation[7] are governed by Chapter 8.

As the precise meaning of "securities" and "futures contracts" is important to an identification of regulatory gaps and other deficiencies, their statutory definitions will be examined first.

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[2] Mallesons Stephen Jaques pointed out that whether an interest rate swap is an adjustment contract and therefore a futures contract will depend on whether the swap contract is a standardised agreement. See legal analysis by Mallesons Stephen Jaques, in their submission to the ASC reprinted in Group of Thirty, Global Derivatives Study Group, 'Derivatives: Practices and Principles - Appendix II: Legal Enforceability: Survey of Nine Jurisdictions', Washington, 1993, (.Mallesons Submission) Attachment A, paragraphs 1, 2 & 3.

[3] See legal analysis by Mallesons Stephen Jaques, in Mallesons Submission, note 1, paragraph 6.

[4] *Carragreen Currency Corporation Pty Ltd* v *Corporate Affairs Commission (NSW)*, (1987) 5 ACLC 148 at 159.

[5] *Carragreen*, note 4, 148.

[6] Under section 92A of the Corporations Law.

[7] Under section 72A of the Corporations Law.

5.2.1 *The definition of "securities"*

The term "securities" is defined in section 92 to include not only shares and debentures of a body corporate, but also derivatives such as units of shares of a body corporate, prescribed interests and option contracts within the meaning of Chapter 7.[8] Section 92 excludes any contract from being a "security" if it is a "futures contract".[9]

5.2.1.1 Units of shares

Units of shares are derivatives because the term "unit" is defined in section 9 to include an option to acquire a right or interest in shares. An option is a well established category of financial derivatives.[10]

5.2.1.2 Prescribed interests

Prescribed interests may be considered as derivatives in view of its definition. Section 9 defines "prescribed interest" to include a "participation interest" which in turn is defined to include any right or interest in any financial scheme. Such a right or interest was held to exist in *Carragreen Currency Corporation Pty Ltd* v *Corporate Affairs Commission (NSW).*[11] The relevant facts were that Carragreen gave its customers the option of purchasing a stated amount of currency. It then hedged its currency risk by buying and selling foreign currencies through Merrill Lynch. It was held by Hodgson J that this arrangement entered into by Carragreen and its customers exhibited "a communality as between the plaintiff and its customer and that it is appropriate to consider the profits made by the customer as well as the plaintiffs profits, as being profits of this...scheme."[12] Accordingly, it was held that they were "participation interest" which is a form of "prescribed interest."[13]

The difficulty with this decision is that it appears to be at odds with the definition of securities in section 92. Earlier on in the judgment, Hodgson J had held that the contracts were "futures contracts."[14] If they were futures contracts, then it is submitted that they cannot also be "prescribed interests" because "prescribed interests"

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[8] Companies and Securities Advisory Committee, 'Law of Derivatives: An International Comparison', 1995 (CASAC International Comparison), 17.

[9] Another class of contracts excluded from section 92 is "excluded security". This group is ignored for the purpose of the discussion on OTC derivatives as they are concerned only with retirement villages.

[10] See Chapter 3 of this thesis.

X[11] (1987) 5 ACLC 148.

[12] *Carragreen*, note 4, at 162 -166.

[13] See the definition of "prescribed interest" in section 9, Corporations Law.

[14] They were held to be eligible commodity agreements at 159; and a futures option at 161. Both types of contracts are within the definition of futures contract in section 72, Corporations Law.

is a form of "securities" as defined in section 92 and as noted above, section 92 excludes any contract from being a "security" if it is a "futures contract".[15]

Participation interest was again considered in *CAC* v *Lombard Nash International* (No 2)[16] which will be known hereafter as "Lombard Nash (No 2)". Although Carragreen was liberally cited elsewhere in the judgment of Cohen J, it was not referred to in his deliberations on whether the contracts in question might be a participation interest. Carragreen gives rise to legal uncertainty at least in the State of New South Wales where, until overruled by a higher court, it is a binding precedent, and arguably, the case creates legal uncertainty also in the other Australian States where it is persuasive authority. Legislation may be needed to resolve the inconsistency created by Carragreen.

5.2.1.3 Chapter 7 option contracts

As regards the term "option contract" in Chapter 7,[17] it comprises three categories of OTC derivatives:

(1) an option contract giving a person a right to buy or sell a pre-determined number of securities for a period up to a specified date;

(2) an option entered into on an exempt stock market to buy or sell a pre-determined amount of foreign currency or a quantity of a specified commodity at a fixed price, such option being exercisable for a period up to a specified date; and

(3) an option made on an exempt stock market which entitles the option holder the right to be paid an amount determined by comparing a specified number with a specified index.[18]

An OTC option on shares or an OTC warrant over securities[19] would be an "option contract" in Chapter 7.

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[15] This view does not appear to be shared by the Companies and Securities Advisory Committee. In CASAC International Comparison, note 8, CASAC explained at page 18 that although a futures contract cannot be a security, rights granted in respect of some futures contracts could be "prescribed interest" because the prescribed interest definitions do not exclude futures contracts, as does section 92 of the Corporations Law. It is submitted with the greatest respect that such an interpretation, arguably, would be contrary to the express provision in section 92. By the definition in this section, "prescribed interest" is virtually synonymous with "securities" and because a contract cannot be both a securities and a futures contract, it follows that a prescribed interest cannot be a futures contract.

[16] (1987) 5ACLC 651.

[17] The expression "an option contract in Chapter 7" is defined in section 9 of the Corporations Law. In essence, "an option contract in Chapter 7" means an option over "securities" of a kind referred to in paragraphs 92(1)(a), (b), (c) or (d) which includes debentures and shares of a body corporate.

[18] Section 9 - definition of "option contract" in Chapter 7; CASAC International Comparison, note 8, 17.

5.2.2 *The definition of "futures contract"*

A "futures contract" is defined in section 72 of the Corporations Law. This provides as follows:

"(1) A futures contract is :

(a) a Chapter 8 agreement that is... an eligible commodity agreement or an adjustment agreement;

(b) a futures option; or

(c) an eligible exchange-traded option;

other than:

(d) a Chapter 8 agreement:

(i) that is:

(A) a currency swap;

(B) an interest rate swap;

(C) a forward exchange rate contract; or

(D) a forward interest rate contract; and

(ii) to which an Australian bank, or a merchant bank as defined by subsection (4) is a party;

(e) a Chapter 8 agreement that, when entered into is in a class of agreements prescribed for the purposes of this paragraph."

The definition gives rise to four types of futures contracts, namely, an "eligible commodity agreement", "an adjustment agreement", a "futures option" or an "eligible exchange-traded option". For a derivatives contract to be a futures contract, it must belong to one of these four species of contracts.

5.2.2.1 An eligible commodity agreement

The elements which make up an eligible commodity agreement are firstly, that it must be a "commodity agreement" as defined in section 9 and secondly, that it must be "eligible". The commodity agreement test is satisfied if it can be shown that the contract:

(a) is a standardised agreement,[20] that is, agreement of the same kind as defined in section 54; and

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[19] Australian Securities Commission, 'Report On Over-The-Counter Derivatives Markets', 1994, (ASC Final Report), paragraph 48.

[20] This is referred to in the definition of "commodity agreement" in section 9; the term "standardised agreement" is a defined term and "commodity" is also separately defined.

(b) imposes a Chapter 8 obligation on a party to it to make or accept delivery.

Whether a commodity agreement is "eligible" depends on whether it appears likely to be discharged otherwise than by delivery. If it does, then it qualifies to be an eligible commodity agreement. The test is to be applied at the time of entering into the agreement or, if the contract becomes a commodity agreement only at a later stage, then at that later stage. The intention of the parties to the contract is irrelevant in determining whether the agreement is likely to be discharged by methods other than delivery.

5.2.2.2 An adjustment agreement

The criteria for an adjustment agreement is that it must be a standardised agreement and that it has the effect of imposing a Chapter 8 obligation to pay or giving a Chapter 8 right to receive an amount of money, which will be calculated by reference to a particular state of affairs, including that which relates to fluctuations in the value or price of a commodity. It is a feature of such an agreement that it does not require the delivery of a commodity.

In *Carragreen*[21] which was cited with approval in Lombard Nash (No 2),[22] it was said that for an agreement to be an adjustment agreement a party to the contract must "be in a position under the contract that he will, depending on the circumstances, either have an obligation to pay or have a right to receive an amount of money: it is not sufficient that such person merely have a right to receive an amount of money if he will not under other circumstances also be under an obligation to pay." The ruling in this decision prevents an option ever being an adjustment agreement because the buyer of the option will be conferred the potential right to receive but will not have the potential obligation to pay an amount of money on settlement.[23]

5.2.2.3 A futures option

A "futures option" is either an option or a Chapter 8 right which:

(a) entitles the holder to assume a bought or sold position

(b) at a specified price or value

(c) within a specified time

(d) in relation to an "eligible commodity agreement" or "an adjustment agreement".

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[21] (1987) 5 ACLC 148 per Hodgson J at 160.

[22] (1987) 5ACLC 651 per Cohen J at 659.

[23] CASAC International Comparison, note 8, 14.

Although "option" is not defined, a "Chapter 8 right" is. The definition in section 55 states that a "Chapter 8 right" is a right "whether or not enforceable at law or in equity". It is submitted that this definition in section 55 is a source of difficulty as it is unclear whether it would have the effect of rendering an option over a contract valid and enforceable, even if that contract itself is unenforceable. It seems illogical that a contract could be unenforceable at common law or in equity and yet an option over such a contract would, by virtue of section 55, be enforceable.

The definition given to "futures option" may give rise to regulatory gaps. This is because there is now in existence a wide range of options over financial instruments, and not all of them fall within the definition of a futures option. Those outside the definition will not be a futures contract and consequently will be unregulated by Chapter 8 of the Corporations Law.

5.2.2.4 An eligible exchange-traded option[24]

By definition an eligible exchange-traded option means a contract that is entered into on a futures market of a futures exchange which gives the buyer an option or right to buy or sell a commodity or to be paid an amount of money by reference to an index.[25]

5.2.3 *Problems of definitions*

The examination of the definitions of "futures contract" and "securities" reveals several problems. First, these definitions create regulatory gaps and give rise to the consequences, discussed in paragraph 5.4, which such gaps could cause. Those not within either definition are not regulated by the Corporations Law regime. As such the definitions are dated and fail to take into account the spectrum of financial derivatives now available in the markets.

Second, the definitions of "securities" and "futures contract" are complex and highly technical given that both sections 92 and 72 are built on several layers of definitions. For example, each of the four species of contract in section 72(1) is a defined term in section 9 and the definition for each species is again dependent on other defined terms.

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[24] This category of futures contract is not directly relevant to this thesis as it concerns exchange traded contracts but is mentioned briefly here for the sake of completeness.

[25] Section 9; see CASAC International Comparison, note 8, 16.

Third, the definition of "securities" in section 92 excludes all futures contracts. In view of the decision in Carragreen, discussed above, it is unclear if the exclusion does not apply to "prescribed interest", a type of securities.

Fourth, a number of definitions in section 9 which relate to securities and futures contracts are problematic. The difficulties with the definition of a Chapter 8 right or obligation given in section 55 have been discussed above. Equally problematic is the definition of "standardised agreement" about which much has been written.[26] The definition, coupled with the interpretation placed on it by the courts, has been criticised as being too wide and in consequence, many derivative products which were not intended to be regulated as futures contracts may be regulated as such. As the ASC observed, the increasing use of the ISDA[27] documentation and the trend towards greater homogeneity give rise to uncertainty as to whether a transaction is or is not a futures contract.[28] It rejected the suggestion that futures contracts should contain the element of "fungibility" and recommended that any proposal for law reform should include a review as to whether the standardisation element should be removed from the definition of "regulated derivatives transactions".[29]

Fifth, the exclusions in paragraph 72(1)(d) have raised a number of issues (discussed in paragraph 5.3 of this Chapter) which highlighted the inadequacies of the definition of futures contract. Excluded contracts are largely unregulated in that not being subject to Chapter 8, they fall within the regulatory gap unless they are securities as defined in section 92 or prescribed under section 92A. Also these contracts are not protected from the consequences of illegality provided by section 1141. Added to this is the problem of the absence of definition of the contracts listed in paragraph 72(1)(d) which brings about a degree of legal uncertainty as to whether some contracts are excluded contracts.

The above are a summary of some of the inadequacies arising from the definition of terms associated with section 72 and 92. It is clear that the risks, particularly legal risks, are increased by the failure of the Corporations Law to address the deficiencies in key definitions. Other deficiencies in the Corporations Law regime are, where relevant, highlighted below in relation to the discussion on the scope of derivatives regulation.

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[26] See CASAC International Comparison, note 8, 19-20; ASC Final Report, note 19, paragraph 65; Currie, JS, *Australian Futures Regulation,* Longman Professional, Melbourne, 1994, 270.

[27] International Swaps and Derivatives Association.

[28] ASC Final Report, note 19, paragraph 65.

[29] ASC Final Report, note 19, paragraph 225, Recommendation 6.

5.2.4 *Scope of derivatives regulation and regulatory gaps*

It is established in the preceding paragraphs that the reach of the Corporations Law extends only to certain OTC derivatives contracts. Most derivatives products are regulated by the Corporations Law as futures contracts.[30] This section of the Chapter focuses on those classes of OTC derivatives which are regulated by Chapters 7 or 8 but whose characteristics as a securities contract or a futures contract are less apparent. Apart from contracts which are obviously "securities" or "futures contracts" discussed in paragraphs 5.2.1 and 5.2.2, the remaining OTC contracts may be divided into the following three groups.

5.2.4.1 OTC futures contract exempted under section 1127

This group comprises of "futures contracts" which have been exempted under section 1127 as exempt futures markets. It will be explained in paragraph 5.3.1 of this chapter that certain futures contracts are not excluded from the definition of "futures contract" under paragraph 72(1)(d) of the Corporations Law even though a bank or merchant bank is a counterparty. These products are often the subject of applications for exemptions under section 1127.[31] An exempt futures market status provides the trader with some advantages. Exemption relieves the participant from the criminal liability that is imposed under Schedule 3 of the Corporations Law in relation to a contravention of section 1123.[32] It also frees the participant from the many regulatory controls in Chapter 8 which would apply had the market been a futures market of an organised exchange.[33] It is to be emphasised, however, that a successful application under section 1127 does not give rise to a total exemption from compliance with the provisions in Chapter 8.

Regulation of participants in an exempt futures market is through Divisions 1 & 2 of Part 8.7 of the Corporations Law, which deals with offences. The provisions proscribing insider trading in sections 1253 and 1254, market manipulation in section 1259, false trading and market rigging in section 1260, false and misleading statements in section 1261, fraudulently inducing a person to deal in futures contracts in section 1262 and dissemination of information about illegal transactions in section 1263 continue to apply to exempt futures markets.[34]

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[30] ASC Final Report, note 19, paragraph 48.
[31] Companies & Securities Advisory Committee, 'Regulation of the OTC Derivatives Market, Discussion Paper', 1995 (CASAC OTC DP), 11, f/n 22.
[32] This section provides that a person must not conduct, assist in establishing or conducting, or hold out that he person conducts, an unauthorised futures market.
[33] Australian Securities Commission, 'Policy Statement 70: Exempt Futures Markets', 1993 (Policy Statement 70), paragraph 16.
[34] Policy Statement 70, note 33, paragraph 17.

The ASC, in its Policy Statement 70, sets out the circumstances under which it is prepared to recommend to the Attorney-General that a futures market is to be declared an exempt futures market. The Policy Statement does not provide comprehensive exemption for derivatives. Its "interim safe harbour" policy in Policy Statement No 70 is limited to transactions which are "futures contracts" made between sophisticated parties.[35]

5.2.4.2 "Futures contract" not excluded under paragraph 72(1)(d)

A futures contract to which a bank is a party but which does not fall under one of the exceptions in paragraph 72(1)(d) is governed by the Corporations Law. So also is a contract which, although listed in paragraph 72(1)(d), does not have a bank or merchant bank as a party thereto. Such contracts would be regulated under Chapter 8 of the Corporations Law. A commodity swap in which the fixed interest rate party pays a specified sum on agreed payment dates and the floating interest rate party pays a fluctuating amount based on the value of an established index on that payment date may be a "futures contract" even though the bank is a party and as such will not therefore be exempt.[36]

5.2.4.3 Futures contracts traded among members of a corporate group

Yet another group are those derivatives contracts carried out among members of a conglomerate by the group treasury. Concerns arise that such intra-group trading activities would constitute the conduct of an unauthorised futures market in contravention of section 1123 of the Corporations Law. This is in view of a decided case which held that futures trading carried out by a private firm on the firm's own premises could be deemed to be trading on futures market. In *Carragreen*[37] the material facts were that Carragreen sold call options over currencies to its customers, using a standard form of contract. It operated its business, including the sale of options, from its own premises. Among the declarations sought by Carragreen was that section 45 of the Futures Industry Code (the equivalent of section 1123 of the Corporations Law) did not apply to it. The company contended that it did not breach section 45 of the Futures Industry Code on the basis that it would be manifestly absurd and unreasonable if the provisions could cause a private party regularly making futures contracts to be guilty of an offence which could result in imprisonment.[38] It was further contended that to be liable the 'place' must be a place similar to a market

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[35] Policy Statement 70, note 33, paragraphs 7 and 11.
[36] CASAC International Comparison, note 8, 22, f/n 47.
[37] (1987) 5 ACLC 148.
[38] At 162.

or exchange and 'facility' in the definition must be in the nature of a market or exchange constituted by some sort of an electronic network.[39] This argument was not accepted by the Court. Hodgson J held that:

> "the infrastructure of the plaintiff does constitute a facility by means of which futures contracts are regularly made, and in my view, the office of the plaintiff is a place at which futures contracts are regularly made, within the meaning of the definition of 'futures market' ..."

The decision of the court in *Carragreen* gives rise to the possibility that intra-group derivatives transactions may be regulated by Chapter 8. Recognising the commercial uncertainty which intra group transactions could create, the ASC in Policy Statement 70 states that for the time being, it does not propose to enforce the provisions in Chapter 8 in relation to transactions between members of the same corporate group.[40]

5.2.4.4 Contracts prescribed under sections 72A or 92A

These contracts, although not relevant to this thesis because they are on-exchange contracts, have been included in this chapter as part of the argument to support the contention that the Corporations Law is inadequate. Prior to the *Corporations Law (Securities and Futures) Amendment Act 1995*, commonly called the "Share Ratio Act" both Chapters 7 and 8 were limited in scope. To provide the Corporations Law regime with a greater degree of flexibility, the Share Ratio Act introduced two new provisions, sections 72A and 92A, into the Corporations Law. The new sections enable the Corporations Regulations to prescribe a new contract - limited to those intended to be traded on exchange - as securities or as futures contracts, regardless of their true legal characteristics.[41] However, there is no mechanism in the Share Ratio Act which enables regulation to be made for off-exchange transactions. Its application is restricted only to instruments traded on organised exchanges.[42] As such, the Act is not applicable to OTC products.

5.3 OTC derivatives contracts not regulated by the Corporations Law

These are derivatives contracts which fall within the regulatory gap. They are neither "securities" or "futures contracts" as defined in sections 92 and 72 respectively nor can section 72A or 92A be employed to bring them within the Corporations Law

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[39] At 162.

[40] Policy Statement 70, note 33, paragraphs 66-69.

[41] Donnan, F, 'The Share Ratio Act: Innovation or Experimentation in Securities Regulation?', *Companies and Securities Law Journal*, Vol14, 1996, 101, at 102.

[42] Donnan, F, note 41, 103.

ambit since these two sections have no relevance to OTC derivatives. Accordingly, they are not subject to the Corporations Law and are not supervised by the ASC.

Given the rapid transformation of OTC derivatives, a number of derivatives now in existence are neither securities nor futures contracts. In general, a derivatives contract is not a "securities" contract if it is not a unit of a share, a prescribed interest or an option contract within the meaning of Chapter 7. It is also not a "futures contract" unless it is an "eligible commodity agreement",[43] "an adjustment agreement",[44] a "futures option"[45] or an "eligible exchange-traded option".[46] Possible examples of OTC derivatives within the regulatory gap are the OTC equity option,[47] interest rate swaps[48] and an OTC option over a share index.[49]

Options are of particular concern in that their classification can be very difficult.[50] Their complexity and the wide range of option products may give rise to regulatory gaps.[51] An example of a derivatives contract within this group is the OTC commodity option. In *Sydney Futures Exchange Limited v Australian Stock Exchange Limited and Australian Securities Commission (Intervener)*[52] the full Federal Court held that a commodity option, if traded on the OTC market, would not be a "securities"[53] or "futures contract".[54]

A second example is the OTC compulsory cash settled option. Legal analysis based on the decision in *Carragreen* and the definitions of securities and futures contracts show that this option is not regulated under the Corporations Law. It was held in *Carragreen* that an option over a commodity is not an eligible commodity agreement if it is compulsorily cash settled.[55]

The above category are products which are outside the definitions of securities and futures contract. Certain products may be within Chapter 8 and yet remain

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[43] See section 9.
[44] Defined in section 9.
[45] Defined in section 9.
[46] Defined in section 9.
[47] Mallesons Stephen Jaques pointed out that whether an interest rate swap is an adjustment contract and therefore a futures contract will depend on whether the swap contract is a standardised agreement. See Mallesons Submission, note 1, paragraphs 1, 2 & 3.
[48] See legal analysis in Mallesons Submission, note 1, paragraph 4.
[49] See legal analysis in Mallesons Submission, note 1, paragraph 6.
[50] CASAC International Comparison, note 8, 23.
[51] CASAC International Comparison, note 8, 23.
[52] Fed No 86/95 (1995) 3 ACLC 369.
[53] Legal analysis for this conclusion was given by Lindgren J at paragraphs 50-57.
[54] Per Lindgren J at paragraphs 58-112.
[55] *Carragreen*, note 4, 159.

unregulated. Two categories are OTC products which although Chapter 8 agreements are either within the group of excluded contracts in paragraph 72(1)(d) or are prescribed under paragraph 72(1)(e) to be excluded contracts.

5.3.1 *Contracts within paragraph 72(1)(d) of the Corporations Law*

Contracts which are within the ambit of paragraph 72(1)(d) of the Corporations Law are a significant group of OTC products as they comprise about two thirds of the total derivatives market in Australia.[56] The distinguishing feature of these contracts is that an Australian Bank or merchant bank is a party. By definition, these contracts are not "futures contracts". They are not regulated under the Corporations Law because the exclusion from the definition of "futures contract" means that Chapter 8 will not apply. However, the bank counterparty in the transaction would be subject to prudential supervision of the Reserve Bank. Additionally paragraph 72(1)(d) contracts would still be subject to the Chapter 7 regulation,[57] if it satisfies the definition of securities in section 92.[58]

Whilst the exclusion of these contracts from being "futures" contracts may have provided a less regulated environment which helped to fuel their dramatic growth, the exclusion has helped to increase the legal risk for those trading in paragraph 72(1)(d) contracts. It has resulted in the removal of the protection afforded to participants under section 1141.[59] This section protects a futures contract from being illegal and from the consequences of illegality if, inter alia, it is traded on an organised exchange or made on an exempt futures market. An exempt futures market is given a precise meaning in section 9. It means a futures market in relation to which a declaration under section 1127 is in force. Contracts within paragraph 72(1)(d) do not qualify as such. Thus if such an excluded contract contravenes the State gaming or wagering legislation, it would be illegal and consequently void and unenforceable.

A second issue relating to paragraph 72(1)(d) is the legal uncertainty in respect of options over interest rate swaps, currency swaps, forward exchange rate contracts, and forward interest rate contracts to which a bank is a party. Although those contracts are expressly excluded from the definition of "futures contract", the Corporations Law is silent on options over them. If paragraph 72(1)(d) does not extend to options, then a regulatory anomaly arises. The options will be regulated but

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[56] Reserve Bank of Australia, 'Survey of Derivatives Market Activity in Australia', Media Release No 95-21, 19 December 1995 (RBA MR 1995), Table 1. The calculation is made from the figures as at end March 1995 provided in Table 1.
[57] CASAC International Comparison, note 8, 21.
[58] CASAC International Comparison, note 8, 22.
[59] Currie, JS, note 19, 45; CASAC International Comparison, note 8, 21 and 22.

not the underlying contracts over which the option is given.[60] This issue is relevant to swaptions, that is, an option over a swap, where the bank is a party.[61]

Thirdly, not all derivatives contracts to which a bank is a party are excluded. Only four classes of contracts are specifically excluded from being "futures contracts". These are:

(a) interest rate swaps;
(b) currency swaps;
(c) forward exchange rate contracts; and
(d) and forward interest rate contracts.

The problem is that none of the contracts enumerated in (a) - (d) is defined in the Corporations Law. This absence of a precise definition is a source of legal uncertainty given the complex nature of modern derivatives as it could give rise to difficulty in determining whether a contract is within the exclusion. Unless it is absolutely clear that a contract is within paragraph 72(1)(d), a derivatives participant may be put to the trouble and expense of applying for exemption under section 1127. Also, as pointed out by the ASC in its Final Report on Over-The-Counter Derivatives Markets[62] the list of transactions excluded from the definition in paragraph 72(1)(d) is arbitrary and lacks a coherent conceptual basis.

Fourthly, the contracts listed in paragraph 72(1)(d) are not excluded unless a bank is a party. If two non bank counterparties enter directly into interest rate swaps, currency swaps, forward exchange rate contracts, and forward interest rate contracts, such a contract would not be excluded from the definition of "futures contract" even though the parties are "sophisticated" parties. Contracts to which both parties are non banks would be subjected to the regulatory regime in Chapter 8 of the Corporations Law and unless approval for exemption has been granted under section 1127, the parties trading in these contracts on the OTC market run the risk of contravening section 1123 which prohibits unauthorised futures markets. The Australian Securities Commission's Policy Statement No 70 indicates that the ASC is prepared to recommend exempt status to a contract which is made between two sophisticated parties but as has been seen from the discussion in paragraphs 5.2.4.1 and 5.2.4.3, Policy Statement No 70 simply does not go far enough to offer a genuine interim safe harbour.

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[60] CASAC International Comparison, note 8, 22
[61] CASAC International Comparison, note 8, 22
[62] ASC Final Report, note 19, paragraph 228.

If the rationale for the exclusion is that banks are subject to prudential regulation by the Reserve Bank, there is no reason why the exclusion should be limited to the four species of contract in paragraph 72(1)(d). Such a narrow range of exclusion does not accommodate market developments as many commercial and banking transactions are caught by the definition of futures contract.[63]

5.3.2 *Contracts excluded by regulation made pursuant to paragraph 72(1)(e)*

In the debate on the Futures Industry Code, the precursor to Chapter 8 of the Corporations Law, it was recognised that there may be contracts caught within the definition of "futures contract" which were not intended to be regulated. This was because the definition for "futures contract" was too wide and conceivably could bring within its ambit "commercial and banking transactions that otherwise would not be regarded as futures contract negotiations."[64]

To overcome this definitional difficulty and to appease the business community, two exclusions were inserted into the definition of "futures contract". The first comprises the four classes of futures contracts now contained in paragraph 72(1)(d) and the second comprises those contracts excluded by regulation. The second exclusion has been retained in the current definition as paragraph 72(1)(e). The rationale for this exclusion, as explained in paragraph 34 of the Explanatory Memorandum ("Explanatory Memorandum") accompanying the Second Exposure Draft of the Futures Industry Bill 1985 (later to become the Futures Industry Code), was to enable "exclusion by regulation of other transactions that are clearly outside the contemplation" of the Futures Industries Code.[65] For that reason,

> " ... it will be necessary to make regulations to exempt certain persons and transactions from the operation of the Bill. For example, certain agriculture or mercantile agents or agents acting on behalf of manufacturers and producers, and bankers conducting a hedge market, may need to be exempt."[66]

Whilst the examples provided in the Explanatory Memorandum are somewhat dated, paragraph 72(1)(e) continues to provide an avenue whereby a class of futures contract may be exempted from compliance with the requirements in Chapter 8. The

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[63] CASAC International Comparison, note 8, 21.

[64] Explanatory Memorandum accompanying the Second Exposure Draft ofIthe Futures Industry Bill 1985, paragraph 34 quoted in Australian Securities Commission, 'Draft Report On Over-The-Counter Derivatives Markets', 1993 (ASC Draft Report), paragraph 82.

[65] Referred to by Currie, JS, note 26, 43.

[66] Explanatory Memorandum accompanying the Second Exposure Draft ofIthe Futures Industry Bill 1985, 19-20 quoted in ASC Draft Report, note 64, paragraph 81.

exemption in paragraph 72(1)(e) relates to products since the exemption from the definition of futures contract is for a "class" of contracts. Most applications for exemptions are for an entire market and for that reason applications are usually sought under section 1127 of the Corporations Law.[67]

5.4 Effect of regulatory gaps on market risks

The above review of the regime in Chapters 7 and 8 has highlighted some of the regulatory gaps as well as deficiencies. Derivatives contracts which do not come within the definition in section 92 or section 72 or in respect of which no regulation has been made pursuant to section 92A or section 72A fall into the regulatory vacuum.

In Chapter 3 of this thesis, it was explained that market risk is the risk of adverse price movement of derivatives contracts. For example, the seller of an option runs the risk that the value of the underlying asset moving in the wrong direction; and in that event, the losses which the seller incurs could be unlimited. This is not credit risk or legal risk but market risk.

Such adverse price movements could be caused by natural market forces of supply and demand but, equally, it could be caused by manipulative and other unfair practices. Market abuses include fraud, manipulations of prices and insider trading.

Both Chapters 7 and 8 of the Corporations Law contain statutory offences intended to deter the unscrupulous from bad market practices. However, these provisions cannot apply to products falling outside the Corporations Law regime. Regulatory gaps provide an environment which is conducive to unfair and undesirable market practices because the statutory safeguards under the Law regime to protect investors would not be available. The ASC would have no power to impose or enforce the offences provisions in Chapters 7 and 8.[68] Prices of contracts subject to manipulation or unfair practices would be volatile giving rise to market risks. Additionally, a market which is plagued by undesirable conduct could lead to a lack of investor confidence. This could result in diminished volume of trading which in turn could trigger an increase in price of derivatives products.

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[67] Currie, JS, note 26, 43.

[68] If a transaction is not regulated by Chapter 7 or Chapter 8 of the Corporations Law, the investor may not be entitled to the protection afforded by these regimes and must depend for their protection on general legislation such as the *Trade Practices Act 1974* (Cth) and the Crimes Act or Fair Trading Act of the States. The extent of the protection given under general legislation is not as wide as that under the Corporations Law.

5.5 Effect of regulatory deficiencies on credit risks

Credit risk in a derivatives transaction refers to the risk of default by a counterparty to the contract. To take the example of an option contract, the primary risk for the buyer of the option is credit risk. The buyer faces the uncertainty that the seller may fail to perform. If the seller defaults, the buyer's loss would be equal to the amount the buyer could realise from immediately exercising the option plus the opportunity cost which is the buyer's right to wait out the option period to determine if the underlying's value continues to change in its favour.[69]

One of the most obvious reasons for non-performance is the insolvency of the counterparty. Unlike exchange traded contracts which are short-term, OTC contracts are for relatively longer periods with some extending to ten years or more.[70] The longer the time span to settlement or expiry of the contract, the greater the chances of default or non performance as a counterparty's credit standing could deteriorate signif cantly within a relatively short time.

To minimise credit risk, OTC derivatives participants may enter into bilateral netting arrangements which allows two parties to a series of derivatives transactions to add up all positive and negative values of those transactions to produce a single net figure.[71] By means of a netting arrangement, a party is able to terminate a derivatives contract if the counterparty becomes insolvent and to calculate the termination values of each party's obligations and then to "net" or set off the termination values to arrive at a net figure.[72] Credit exposure of the parties will be greatly reduced by this process of set off.

Unfortunately, however, the present legal position regarding netting is uncertain. If, as will be discussed in paragraph 5.6 of this Chapter, the provisions of the Corporations Law and the *Bankruptcy Act 1966* override contractual netting provisions so as to render such netting provisions ineffective, this will have a significant effect on credit risks. Credit risks are often reflected in higher cost of a product, making a product less competitive in the international market. Given that most OTC contracts are made for huge amounts, the opportunity costs could be high

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[69] Hu, H, 'Misunderstood Derivatives: The Causes of Informational Failure and the Promise of Regulatory Incrementalism', *Yale Law Journal*, Vol 102, No 6, 1457-1513, April 1993.

[70] Policy Statement 70, note 33, paragraph 22(c).

[71] Gizycki, M & Gray, B, 'Default Risk and Derivatives: An Empirical Analysis of Bilateral Netting' RDP 9409, Economic Research Department, Reserve Bank of Australia, December 1994, 1 & 14.

[72] Companies & Securities Advisory Committee, Netting Sub-Committee, 'Netting in Financial Markets Transactions, Draft Report', November 1996 (CASAC Netting DR), 1-2.

if players shift their funds to countries overseas where transaction outcomes could be predicted with a greater degree of certainty.

A perceived "gap" in the legal structure is the absence of any statutory provision which overcomes the legal uncertainty as regards the effectiveness of netting arrangements. Such a "gap" could be addressed simply by introducing a new provision in the Corporations Law, much along the same lines as section 1141. Adopting the language in section 1141, such a provision could, for example, state that "nothing in the Corporations Law or a law about bankruptcy or insolvency prevents the entering into of or affects the validity of netting arrangements or contracts in relation to financial derivatives." Alternatively, as the Netting Sub-Committee of the Companies & Securities Advisory Committee proposed,[73] a stand-alone enactment to be known as 'Close Out and Market Netting Act' could be enacted by the Commonwealth Parliament.[74]

5.6 Regulatory gaps and legal risks

The regulatory gaps and deficiencies identified in the Corporations Law structure give rise to three categories of legal risk:

- criminal risk - the risk of incurring a criminal liability;
- civil risk - the risk of loss by reason of a transaction being unenforceable; and
- risks of exposure to fraudulent and other unfair market practices due to the unavailabilty of the statutory safeguards under the Corporations Law regime.

5.6.1 *Criminal liability*

The failure of the law to provide more comprehensive protection for derivatives participants in sections 778 and 1141 exposes them to criminal liability in relation to some derivatives contracts. In their existing forms, both sections 778 and 1141 are limited in scope. Their protection to investors extends only to all futures contracts and options contracts traded on a stock exchange or an exempt market. A number of derivatives contracts are neither futures contracts nor exchange traded options contracts. Should these contracts fall within the ambit of State gaming legislation, investors trading in them could run the risk of incurring criminal liability.

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[73] CASAC Netting DR, note 72, 5.

[74] It is uncertain whether the Commonwealth would have the constitutional powers to legislate such a stand alone netting Act. The issue of constitutional powers was mentioned briefly on page 27 of Companies & Securities Advisory Committee, Netting Sub-Committee, 'Netting in Financial Markets Transactions, Background Paper', December 1996 (CASAC Netting Background Paper). The subcommittee stated that it believed the Commonwealth had ample powers to act but it was unclear if the issue had been examined fully by CASAC.

Secondly, the definition of "futures contract" and "futures market" in the Corporations Law are so wide that participants could be exposed to criminal liability for conducting unauthorised futures market unwittingly, in breach of section 1123.[75] These definitions create legal uncertainty for a broad range of transaction in the OTC markets giving rise to concern that Chapter 8 regulates OTC transactions,[76] including those that are carried out between companies in a corporate group by the group treasury.[77] An offender who infringes section 1123 could incur a fine of up to 200 penalty units or imprisonment of five years or both.

5.6.2 *Unenforceable contracts*

The second category of legal risks, the risk of economic loss due to the unenforceablity of a contract, was discussed at some length in Chapter 3 of this thesis. A contract may be unenforceable because it is illegal, the counterparty has no capacity or is not empowered to enter into the contract, the counterparty is insolvent or protected by crown immunity. This category of risk may be attributable to the failure of the Corporations Law to provide adequate protection to OTC investors in the following areas:

(a) Consequences of illegality and inadequacies of subsection 103(2) and sections 778 and 1141

As noted earlier in this paragraph 5.6, there is a danger that participants in some derivatives contracts may breach the State gaming and wagering regime or contravene section 1123 which legislates against unauthorised markets. A contract made in contravention of legislation is illegal and consequently void except where legislation provides otherwise. Whilst sections 778 and 1141 and subsection 103(2) save some derivatives contracts from the consequences of illegality, they do not go far enough.

The effect of subsection 103(2) is that a derivatives contract made in contravention of say, section 1123 - which is a provision within Chapter 8 - would not be invalid and would be enforceable even though it may still attract criminal liability. If a derivatives product is found to have contravened a law other than the provisions in Chapter 8, subsection 103(2) will be of no

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[75] The penalty for this offence is 200 penalty units and/or imprisonment for 5 years.

[76] Policy Statement 70, note 33, paragraph 21.

[77] Recognising this as a problem, the ASC in its Policy Statement 70, note 33, at paragraphs 66 - 69, advised that it sees no benefit in enforcing the provisions of Chapter 8 of the Corporations Law in relation to intra group transactions; see the discussion in this chapter on Policy Statement 70. See also ASC Final Report, note 19, paragraph 168.

assistance because the resulting invalidity is not due to a contravention of Chapter 8 but of those other laws.

Other than section 1123, one of the most likely causes of illegality is a contravention of the gaming and wagering laws of a State or Territory. Although sections 778[78] and 1141[79] of the Corporations Law protect all exchange traded option contracts and all futures contracts traded on an organised exchange or an exempt market from illegality arising from a contravention of gaming and wagering legislation, they do not save all derivatives contracts. Sections 778 and 1141 provide protection only if the contracts are exchange traded or if they are traded on an exempt market.

The focus of this thesis is on the OTC instruments. In relation to these products, neither section 778 nor section 1141 is capable of providing any relief or protection to investors who fall foul of State gaming legislation unless the contracts are traded on an exempt market. The failure of the Corporations Law to provide similar protection to investors in the OTC market in this respect creates a serious regulatory gap, in view of the size of the OTC markets. Such a failure is an anomaly in that two contracts with similar functions and characteristics are not given the same regulatory treatment.

(b) Regulatory gaps and the ultra vires principle

A legal risk which participants have to face in their dealings with some counterparties is the legal capacity of these counterparties. The question of capacity to enter into derivatives contracts arises where a trust, a local authority, a life insurance company[80] or a friendly society or building society, is a party to the contract. For the reasons given in Chapter 3, it will also arise where incorporated associations[81] and foreign companies[82] are counterparties.

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[78] This provides that "Nothing in a law of this jurisdiction about gaming or wagering prevents the entering into of, or affects the validity or enforceability of an option contract entered into on: (a) a stock market of a securities exchange; or (b) an exempt stock market."

[79] Section 1141 provides that "Nothing in a law of this jurisdiction about gaming or wagering prevents the entering into of, or affects the validity or enforceability of a futures contract made: (a) on a futures market of a futures exchange ...; or (b) on an exempt futures market; or (c) as permitted by the business rules of a futures association, of a futures exchange or of a recognised futures exchange."

[80] CASAC Netting Background Paper, note 74, Appendix D examines the limitations on the power of life companies to enter into swap transactions. This Background Paper noted, in particular, the restrictions imposed by s43, s38(4) and 38(2) of the *Life Insurance Act 1995* (Cth).

[81] Phillips, J & O'Donovan, J, *The Modern Contract of Guarantee*, second edition, the Law Book Company Limited, 1992, 47, citing *Rosemary Simmons Memorial Housing Association Ltd v United Dominions Trust Ltd*, (1987) 3BCC 65.

[82] Foreign companies are not companies within the meaning of section 9 of the Corporations Law.

The extent of the powers of a local authority is determined by its enabling legislation, whilst the capacity of a friendly society[83] or building society to enter into a derivatives contract is dependent upon the rules of the society as well as the legislation under which it is incorporated. For example, a building society does not have complete freedom to enter into financial derivatives contracts. Section 120 of the Financial Institutions Code imposes two restrictions on building societies wishing to enter into futures contracts and other transactions referred to in subsection 120(2). A building society would have the capacity to be a party only if the derivatives contract is one of the "approved financial contracts" in subsection 120(2) and the society has "passed" the purpose test in subsection 120(3).[84]

It is expected that the doctrine of ultra vires will have the greatest impact on trusts as some of the most significant financial entities in Australia are trusts.[85] Many of the older and more established trusts pre-date the advent of the new generation of financial derivatives and trustees may not be empowered by the terms of the trust to trade in them.

The House of Lords in *Hazell v Hammersmith and Fulham London Borough Council and Others*[86] left open the question of whether payments made pursuant to ultra vires swap agreements were recoverable or not. In *Westdeutsche Landersbank Girozentrale* v *Islington London Borough Council*[87] it was established that participants need not incur losses through the application of the ultra vires principle. The effects of the ultra vires doctrine is that a transaction which is beyond the powers of an entity is void ab initio.[88] However, any monies paid under a void derivatives contract may be recovered from the recipient on the basis that it is a mistake of fact or law[89] or on the basis that as the contract is void, no consideration has been given for the making of the payment.[90]

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[83] A detailed analysis of the powers of friendly societies in New South Wales and Victoria to engage in swap transactions is contained in CASAC Netting Background Paper, note 74, Appendix E.
[84] CASAC Netting Background Paper, note 74, Appendix F.
[85] CASAC Netting Background Paper, note 74, 4.
[86] [1990] 3 All ER 33.
[87] (1996) 2 All ER 961.
[88] *Westdeutsche Landersbank Girozentrale v Islington London Borough Council* (1996) 2 All ER 961 at 966 per Lord Goff.
[89] It has now been firmly established by the High Court in *David Securities Pty Ltd v Commonwealth Bank of Australia* (1990) 93 ALR 271 that a mistake of law is no bar to recovery of monies.
[90] *Westdeutsche,* note 88, at 968 Per Lord Goff approving the decision of Hobhouse J in *Westdeutsche Landersbank Girozentrale v Islington London BC* (1994) 4 All ER 890.

As regards insolvency of a participant, substantial losses could be incurred by the counterparty because the counterparty, as an unsecured creditor, is not entitled to any priority of payment.

Monies paid over to a party under a derivatives contract could have been accorded priority over other creditors in the event of insolvency if the monies could be said to be trust monies. This is on the basis that monies subject to a trust are not monies of the insolvent party. However, the House of Lords in *Westdeutsche Landersbank Girozentrale* v *Islington London Borough Council*[91] held that a local authority, as a recipient of money under a contract subsequently found to be ultra vires, did not hold the money under a resulting trust. As was pointed out by Lord Brown-Wilkinson[92] and Lord Goff,[93] on receipt of the money by the recipient, it is to be presumed that the identity of the money is immediately lost by mixing with other moneys of the recipient. At that time, the recipient has no knowledge of the facts giving rise to a failure of consideration. By the time the lack of capacity of the recipient comes to light, there will be no identifiable fund to which a trust can attach. Once an identifiable fund ceases to exist, the recipient could not be a trustee.[94] Although English precedents are not binding on Australian courts, the *Westdeutsche Landersbank* case is persuasive authority and could represent the common law position in Australia.

To summarise, an investor could incur losses where the counterparty does not have the capacity to enter into the transaction. If the recipient is solvent, expensive litigation costs could still be incurred in the event that the counterparty is unwilling to repay the monies received by it pursuant to the void contract. Second, if the counterparty who is afflicted by a lack of capacity goes into insolvency, the investor will not be entitled to any priority and will need to share in the assets of the insolvent counterparty together with other unsecured creditors. A possible third head of loss is "opportunity costs" in respect of those contracts intended to hedge the investor's financial risks or intended to generate a profit. As the contract is void ab initio, no hedging protection could be given or profit could be made.

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[91] (1996) 2 All ER 961.
[92] At 990.
[93] At 973.
[94] Per Lord Brown-Wilkinson, at 990 citing *Re Goldcorp Exchange Ltd (in receivership)* (1994) 2All ER 806.

No protection is given to investors in the Corporations Law against losses incurred by virtue of the operation of the ultra vires doctrine. Parliament has seen fit to enact sections 778 and 1141 to shield investors from effects of illegality occasioned by infringement of the gaming and wagering regime. It is submitted that the rationale which led to the enactment of sections 778 and 1141 applies equally to ultra vires contracts. A provision similar to section 778 or 1141, if enacted to protect investors against the effects of an ultra vires contract, will address the regulatory deficiency in the existing Corporations Law regime and go a long way to providing legal and commercial certainty.

(c) Insolvency of the counterparty

The current unsatisfactory state of the law in relation to insolvencies of legal entities gives rise to considerable legal risks for participants in the OTC derivatives markets. As explained in Chapter 3 of this thesis, a transaction which is not yet completed may be disclaimed by the liquidator[95] if it is unprofitable and a transaction which has been completed may nevertheless be set aside under the doctrine of relation-back[96] or the doctrine of preference.[97] The operation of these doctrines calls into question the effectiveness of netting arrangements as a means of reducing credit exposure to a counterparty and thereby reducing credit risks.

Division 2 of Part 5.7B[98] of the Corporations Law governs transactions, including financial derivatives, made on or after 23 June 1993. Its introduction has not helped to eliminate concerns in relation to netting provisions. As explained below, subsection 588FA(1), which deals with unfair preference, arguably widens the scope for "claw-back" and enhances legal risks in the OTC markets.

The test for undue preference, as provided in paragraph 588FA(1)(b), is whether a transaction would result in a creditor receiving from the insolvent company, in respect of an unsecured debt that the insolvent company owes the creditor, more than what the creditor would receive from the insolvent company in respect of the debt if the transaction was set aside and the creditor

[95] Paragraphs 568(1)(d), (e) or (f) of the Corporations Law; sections 133(1AA), 133(1AB), 133(1), 133(1A) of the *Bankruptcy Act 1966* (Cth).

[96] Commencement of bankruptcy is deemed to relate back to the first act of bankruptcy committed by the debtor within 6 months prior to the creditor's petition: section 115 of the *Bankruptcy Act 1966* (Cth); but see also section 123 of the same Act.

[97] Section 122 of the *Bankruptcy Act 1966* (Cth); Section 565 of the Corporations Law.

[98] Introduced by the *Corporate Law Reform Act 1992*.

were to prove for the debt in a winding up of the company. In a typical bilateral netting arrangement, one party's gain or loss in respect of a contract is set off against the losses or gains in other contracts made with the same counterparty.

Such a netting arrangement could fall within subsection 588FA(1) because subsection 588FA(3) treats all transactions forming part of the relationship as if they together constitute a single transaction.[99] This latter provision puts at risk transactions entered into before the making of netting arrangements as well as subsequent transactions.[100] It has been contended[101] that a bilateral close-out[102] netting arrangement could well be an "unfair preference" and that such netting arrangements could be deemed to be "insolvent transactions" within the scope of section 588FC and thereby voidable and subject to the "claw-back" provision in section 588FE.[103]

The doctrines of relation back and unfair preference were adopted by the legislature in order to protect the interests of creditors of the insolvent party. Against these interests the legislature must balance the potentially competing objective of maintaining systemic stability in and international competitiveness of the Australian financial markets. This is a policy issue which needs to be settled by Parliament.

The derivatives market transcends national boundaries and if Australia is not to be disadvantaged by its archaic insolvency laws in the global market place, its policy need to be in line with those of other trading nations. Legislative and non legislative reforms have been put in place in several countries, including the United States,[104] United Kingdom,[105] and Ireland[106] to promote greater legal certainty in relation to netting arrangements.

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99 Paragraph 588FA(3)(c), Corporations Law.
100 CASAC Netting Background Paper, note 74, Appendix B, 56.
101 See CASAC Netting Background Paper, note 74, 57.
102 "Close out" netting is in fact default netting, and is triggered by specified events of default, entitling the non defaulting party to terminate all incomplete contracts: see CASAC Netting Background Paper, note 74, 7.
103 The transaction will not be set aside by the Court if the solvent party could show that (a) it received the benefit in good faith; (b) it did not suspect the counterparty of being insolvent and (c) a reasonable person would not have suspected that the counterparty could be insolvent: section 588FG.
104 Federal Deposit Insurance Corporation Improvement Act 1991, reproduced in CASAC Netting Background Paper, note 74, Appendix C1.
105 Financial Law Panel (UK), Guidance Notice,: Netting of Counterparty Exposure dated 19 November 1993 and Financial Law Panel (UK): Netting of Counterparty Exposure Foreign Exchange Dealing, 20 September 1994 cited in f/n 7, CASAC Netting Background Paper, note 74, December 1996, 12.

Although enacting netting laws would mean a deliberate preference by the legislature of one group of creditors over ordinary unsecured creditors, it is submitted that such a policy is justifiable on the grounds that netting legislation would significantly reduce systemic risk and consequently protect a greater section of the investing public.

5.6.3 *An unlevel playing field*

Participants in the OTC market place are also exposed to risks due to the presence of regulatory gaps. If a derivatives contract entered into by an investor is unregulated, the statutory safeguards under the Corporations Law regime to protect investors would not be available. A party to a derivatives contract which contravenes the gaming laws of the State would not be able to rely on sections 778 or 1141 to save it from the consequences of illegality.

Further, as explained in paragraph 5.4, regulatory gaps create a conducive environment in which undesirable practices could flourish unchecked because the ASC would have no power to impose or enforce the offences in the Chapters 7 and 8.[107] As the analysis in the next Chapter shows, criminal and consumer laws, even when combined, are inadequate to cover the range of market based offences now proscribed by the Corporations Law.

In Chapter 3 of this thesis, it was noted that some derivatives such as options can be very volatile and that market volatility is enhanced by the leverage opportunities which the products afford.[108] Equally, this volatility could be enhanced by unhealthy market practices carried on by those taking advantage of the regulatory gaps to exploit less sophisticated investors.

5.7 Conclusion

The foregoing review of the Corporations Law regime governing derivatives has identified a number of deficiencies and gaps in the legislative structure. The examination shows that OTC instruments and OTC investors are particularly vulnerable to a range of risks in the derivatives markets. The reasons are fairly

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[106] The Irish Netting of Financial Contracts Act 1995.

[107] If a transaction is not regulated by Chapter 7 or Chapter 8 of the Corporations Law, the investor may not be entitled to the protection afforded by these regimes and must depend for their protection on general legislation such as the Crimes Acts and the *Trade Practices Act 1974* (Cth). The extent of the protection given under such legislation is not as wide as that under the Corporations Law.

[108] Hains MG, 'Futures Contracts: Do They Include Forwards and Swaps?', in Walker, G, & Fisse, B, *Securities Regulation in Australia and New Zealand*, Oxford University Press, Auckland, 1994, 848.

obvious. Exchange traded derivatives are always subject to the Corporations Law, the Business Rules of the exchanges and Business Rules of the clearing houses but OTC products may not be. In fact, the majority of OTC products are unregulated. Another reason is that many of the 'investor protection' provisions in the Chapters 7 and 8 are applicable only to exchange-traded products. This is understandable as the policy underlying securities and futures regulation is investor protection and it is in recognition of the perils of an unregulated market place that the legislature has made the "on market dealing" rule a cornerstone of the investor protection regime in Chapters 7 and 8. The rule is evidenced by a clear legislative preference in the Corporations Law for transactions to be traded on organised exchanges. It ensures that transactions made through a broker are made on a closely regulated market and are subject to the stringent requirements of the exchange and clearing house rules and to the statutory safeguards of the Corporations Law which make it mandatory for brokers and advisers to be licensed[109] and for futures brokers to provide adequate disclosure of trading risks to investors prior to trading.[110]

The derivatives markets are not static as derivatives products continually undergo changes. Already some derivatives products are available at retail level. Lenders selling capped loans would be selling loans with an embedded derivative. With the rapid innovation in OTC derivatives instruments, it would be a matter of time before OTC products are also readily available to retail investors. When this happens, there will be little difference conceptually between investors trading on organised exchanges and those retail investors trading in the OTC markets. It is submitted that there is a strong argument for equal treatment to be afforded out to unsophisticated participants in both markets. The Corporations Law, as it stands, is not designed to accommodate development of an OTC retail market.

On the assumption that no changes are to be made to the Corporations Law, it may be asked if there is adequate protection for retail investors from other sources of the law. The next Chapter looks at the general law[111] to determine the extent to which they have the capacity to act as a credible substitute for the gaps in the Corporations Law.

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[109] Sections 780, 781, 1142 and 1143, Corporations Law.
[110] Section 1210, Corporations Law.
[111] The term "general laws" used here refers to the criminal and consumer laws.

CHAPTER 6

IDENTIFYING THE GAPS IN CRIMINAL AND CONSUMER LEGISLATION

6.1 Introduction

This Chapter's main objective is to gauge if protection equivalent to that provided under Chapters 7 and 8 of the Corporations Law is available under the general law underpinning the legal system, such as the criminal and consumer laws. Of relevance are those laws which, although they are not specifically directed at the derivatives participants, offer general protection against white collar crime and other undesirable conduct. As indicated in Chapter 2 of this thesis, enactments which have been identified as providing investor protection are the Crimes Acts of the States, the *Trade Practices Act 1974* (Cth) and consumer legislation of the States, which includes the Fair Trading Acts of individual States.[1]

The previous Chapter has identified a number of gaps and deficiencies in investor protection in Chapters 7 and 8 of the Corporations Law. This Chapter continues with the evaluation of the regulatory framework for the OTC markets to determine the extent of protection given by general law to investors in transactions which are outside the ambit of the Corporations Law. By this process, it is also possible to identify areas of the OTC derivatives markets which are totally unregulated. At the same time, the limitations in the sanctions regime of the Corporations Law pertaining to futures and securities are also identified. The capacity of the statutory framework to control malpractices in the OTC markets is important from the perspective of investor protection. If protective mechanisms are not in place or are inadequate, unsophisticated investors will be exposed to fraudulent or manipulative practices and consequently could incur financial losses arising from such activities.

Given the similarity between the *Trade Practices Act 1974* (Cth) ("TPA") and the Fair Trading Acts of individual States and Territories in respect of those provisions under consideration in this chapter and the similarity of the Crimes Act among the majority of the States, it is proposed that only the TPA and the *Crimes Act 1900* (NSW)

[1] *Fair Trading Act 1987* (NSW), *Fair Trading Act 1989* (Qld), *Fair Trading Act 1987* (SA), *Fair Trading Act 1990* (Tasmania), *Fair Trading Act 1985* (Vic) and *Fnir Trading Act 1987* (WA). Some other relevant enactments are *Contracts Review Act 1980* (NSW);

("Crimes Act") be examined. New South Wales is one of the most significant of the Australian States in terms of corporate activities. For this reason the Crimes Act is used here for comparison against the Corporations Law investor protection provisions.

As explained in paragraph 2.2.2 of this thesis, the common area for comparison in all three enactments (the Corporations Law, the TPA and the Crimes Act) is in respect of offences against property. Accordingly, the comparative study is made between the offences provisions in Divisions 1 & 2 of Part 8.7 and Parts 7.11 and Division 6 of 7.12 of the Corporations Law and corresponding provisions in the Crimes Act and TPA. Statutory offences were introduced into the securities and futures legislation in an attempt to curb a range of abuses against investors. These offence provisions are directed at conduct which is deemed to be harmful to participants. The offence provisions of Chapter 8 of the Corporations Law are modelled on those of the Securities Industry Code[2] and as such are largely similar to those in Chapter 7 of the Corporations Law. Some of the sanctions provisions of the Corporations Law, such as section 995 which deals with misleading or deceptive conduct in connection with takeovers, issue of prospectus, allotment or dealing of securities but which creates no offence,[3] section 996 which concerns the issue of prospectus[4] or section 1266 which is aimed at the exchange traded markets, are arguably of little relevance to the OTC derivatives markets. Some are, however, clearly applicable and these will be examined in some detail.

In the OTC market, undesirable practices comprise fraud, manipulation of the market through a variety of ways and practices which although not criminal or misleading or deceptive in nature, nevertheless are unacceptable from an investor's point of view because of the economic loss that could flow from those activities.

Abusive practices in the derivatives market may be grouped as follows:

1. Offences peculiar to the futures and securities markets, such as insider trading, hawking, frontrunning and bucketing.
2. Manipulative conduct such as those involving misleading, deceptive and unconscionable conduct.
3. Conduct involving fraud.

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[2] Hains, MG, 'Futures Trading Offences' in *Australian Corporations Law: Principles and Practice*, Vol 3, Butterworths, 1991, 81,304.

[3] Subsection 995(3) of the Corporations Law.

[4] In the context of derivatives which are securities, prospectuses are not expected to be required except for the on-exchange markets. This thesis deals with OTC and not on exchange derivatives.

There is no strict demarcation between these groups and some malpractices fit in to more than one category. The following table is a summary of securities and futures offences proscribed by the Corporations Law and, where applicable, their equivalent under the TPA and the Crimes Act. It is noted that although the offences provisions in the Corporations Law are designed specifically to cover malpractices in the capital markets, there is some degree of overlap between these provisions and those in the consumer legislation such as sections 45, 46, 52 and 53 of the TPA.[5] There is also some degree of overlap with provisions in criminal legislation such as sections 178BA,[6] 178BB[7] and 185A[8] of the Crimes Act. These offences will be analysed to determine if they provide protection to investors which are similar to those in the Corporations Law.

The table appearing in the following page provides a summary of the comparison between the sanctions provisions of the Corporations Law and the TPA as well as the Crimes Act.

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[5] These provisions in the TPA are discussed in detail in paragraphs 6.2 to 6.4 of this Chapter. Additionally, sections 52 and 53 are discussed in greater detail in Appendix 1 of this thesis.
[6] Subsection 178BA(1) provides that "Whosoever by any deception dishonestly obtains for himself or another person any money or valuable thing or any financial advantage of any kind whatsoever shall be liable to imprisonment for five years."
[7] This section provides that "Whosoever, with intent to obtain for himself or another person any money or valuable thing or any financial advantage of any kind whatsoever, makes or publishes or concurs in making or publishing any statement (whether or not in writing) which he knows to be false or misleading in a material particular and is made with reckless disregard as to whether it is true or is false or misleading in a material particular shall be liable to imprisonment for five years."
[8] Section 185A provides that:
"Whosoever, by any statement, promise, forecast which he knows to be misleading, false or deceptive, or by any dishonest concealment of material facts, or by reckless making (dishonestly or otherwise) of any statement, promise or forecast which is misleading, false or deceptive, induces or attempts to induce another person to take part or offer to take part in any arrangement with respect to property other than marketable securities, being arrangements the purpose or effect or pretended purpose or effect, of which is to enable persons taking part in arrangements (whether by becoming owners of the property or any part of the property or otherwise) to participate in or receive profits or income alleged to arise or to be likely to arise from the acquisition, holding, management or disposal of such property, or sums to be paid or alleged to be likely to be paid out of such profits or income, shall be liable to penal servitude for five years."

Figure 4

offence	*Corporations Law*	*Crimes Act 1900 (NSW)*	*TPA 1974 (Cth)*
Dissemination of information (eg runs)	Securities: S1001 Futures: s1263	-	-
Hawking	Securities: s1078 Futures: -	-	-
Insider dealing	Securities: s1002G, 1013 Futures: s1253, 1254	-	-
Dealings by Futures Brokers (eg bucketing)	Securities: - Futures: si258	-	-
Sequence of Transmission and execution of orders (eg frontrunning)	Securities:[9] Futures: si266	-	-
False trading and market rigging (eg. wash sales, matched orders)	Securities: s998 Futures: si260	s178BA s178BA	s52
False or or misleading statement	Securities: s999 Futures: si261	s178BA, 178BB s178BA, 178BB s185A	s52
Fraudulently inducing dealing (eg churning)	Securities: s1000 Futures: s1262	s178BA, 178BB s178BA, 178BB s185A	-
Fraud (eg churning)	Securities: - Futures: si264	s185A	s52
Market manipulation (eg corners, squeezing)	Securities: s997 Futures: s1259	- -	s45, s50 s45, s50

The above table (Figure 4) is based on a review of the relevant provisions in the Corporations Law, the Crimes Act and the TPA. Paragraphs 6.2 to 6.4 of this

[9] Section 844 of the Corporations Law prohibits frontrunning but only in relation to exchange traded securities contracts. This section has no application to OTC securities.

Chapter and Appendix One[10] of this thesis provide the comparative analysis from which Figure 4 is constructed. It indicates that the general consumer and criminal legislation cannot be depended upon to provide an alternative means of protection for investors trading in the OTC market in respect of transactions which are not governed by the Corporations Law. This constitutes a serious gap in the legislative framework in terms of delivering investor protection.

6.2 Offences peculiar to the futures and securities markets

The sanctions regime in Chapters 7 and 8 of the Corporations Law is not so much directed at outright criminal conduct such as fraud and misappropriation of monies - these being adequately addressed by the criminal legislation of the States - but rather at certain conduct which may be described as typical abuses which are made possible by conditions prevailing in the futures and securities markets. The abuses (discussed below) include bucketing (prohibited by section 1258 of the Corporations Law) frontrunning (prohibited by sections 844, 1264 and 1266 of the Corporations Law), insider trading (prohibited by sections 232(5), 1002G, 1013, 1253 and 1254 of the Corporations Law) and hawking (prohibited by section 1078 of the Corporations Law). Because these offences do not occur except in the capital markets, they are not caught under the general criminal or consumer legislation. This constitutes a major regulatory gap in investor protection as any OTC contract which is unregulated by Chapters 7 and 8 of the Corporations Law is exposed to these market abuses. A perpetrator may, in respect of such a contract, carry out one or more of these malpractices with impunity, secure in the knowledge that there is no legislation under which he or she could be called to account. The extent of the regulatory gap in relation to sanctions regimes in criminal and consumer legislation is explored in the analysis below.

6.2.1 *Dealing by broker on behalf of others (section 1258 of the Corporations Law)*

Section 1258 is aimed at discouraging brokers' abuse, a practice which is called "bucketing". An example of bucketing is where the broker accepts a client's orders for sale or purchase of a futures contract (intended to be executed on a futures market) but fails to pass on the order for execution either in the OTC market or on the floor of the exchange. Instead the broker does one of two things: either takes the other side of the transaction, acting as a principal or alternatively, the broker matches the client's

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[10] Appendix 1 of this thesis contains the analysis of sections 52 and 53 TPA against the equivalent provisions in the Corporations Law sanctions regime. References in paragraphs 6.2 to 6.4 of this Chapter which pertain to sections 52 or 53 TPA need to be read in conjunction with Appendix 1.

orders with equal and opposite orders of the broker's other clients to maximise its profit.[11]

One form of bucketing is leverage currency transactions. Transactions involving leverage currency provide opportunities for abuse as the broker does not warrant that it will trade on the exchange. In leverage currency transactions, the broker acts as the principal with its client and allows the client's losses to mount, closing out on the transaction when the client is in a loss position. As derivatives transactions are "zero sum games", the loss to the client represents an equivalent gain to the counterparty who is the broker.[12]

Section 1258 makes it an offence for a broker to deal in a futures contract on behalf of clients unless the dealing is effected on an exchange or on an exempt futures market. By compelling transactions to be dealt on exchange (except for those traded in exempt markets), the opportunity for brokers to take the opposite side of the transaction is removed. Section 1258 thus creates a contract market monopoly by virtue of which no futures contract can be traded unless "the dealing is effected on ...a futures exchange; ...an exempt futures market; or ..as permitted by the business rules of a futures organisation.."

This provision would have the effect of eliminating the broker's opportunity for bucketing in relation to most OTC futures contracts.[13] All OTC futures contracts are traded in an exempt futures market and as such, a broker dealing with such a contract is prohibited by section 1258 from bucketing. It is to be emphasised that section 1258 does not prevent bucket shops from operating in relation to other derivatives contracts which are not futures within the definition of section 72 of the Corporations Law. As such section 1258 is of limited application.

Investors are not protected if they trade in an OTC derivatives contract unless it is a futures contract. This is particularly so as neither the TPA nor the Crimes Act contains any provision which prohibits bucketing. The absence of legislation in this area constitutes a regulatory gap which needs to be addressed.

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[11] Currie, JS, *Australian Futures Regulation,* Longman Professional, Melbourne, 1994, 88.
[12] Gunningham, N, 'Futures Market Regulations in Australia' in Walker, G, & Fisse, B, *Securities Regulation in Australia and New Zealand,* Oxford University Press, Auckland, 1994, 821.
[13] See the discussion on bucket shops in Hazen, TL, 'Rational Investments, Speculation, or Gambling? Derivative Securities and Financial Futures and their Effect on the Underlying Capital Markets", 86 *Northwestern University Law Review,* 1992, 987 at 1016.

6.2.2 *Sequence of transmission and execution of orders (sections 844 and 1266 of the Corporations Law)*

Frontrunning refers to a situation in which the broker allows the sequence of transmission and execution of orders to apply in such a way that the broker has an advantage over the client.[14] A broker may be tempted to enter the futures market in competition with its client if it is aware that the client has placed or is soon to place a significant order which has the capacity to influence price in a particular futures market.[15] The broker's strategy in such a case is to buy ahead of its client, on the basis of the information, so as to improve its chances of making a profit.

Sections 844 and 1266 of the Corporations Law are intended to prevent "frontrunning." In essence, section 844 prohibits a securities dealer from buying or selling securities on a stock exchange (on its own account) if a client has instructed the dealer to buy or sell, as the case may be, securities of the same class, unless the dealer has complied with the client's orders. This section does not apply to the OTC securities market as its operation is limited to transactions traded on organised exchange.

Section 1266 requires a futures broker to transmit clients' orders in the sequence in which they are received. In situations where the broker also deals on its own behalf, subsection 1266(3) requires that the client's orders take priority over the broker's own orders. However, as Carley[16] pointed out, section 1266 lags well behind the realities of the market and trading strategies of market players, including brokers. For example, section 1266 does not cover dealings in options in related markets[17] or other forms of derivative instruments. The close linkage between a particular market and related markets for its derivative products would be likely to create a "flow through" effect in the related markets if the client's order is sufficiently large. Also, section 1266 applies only to futures contracts and is not applicable to the broad range of OTC derivatives contracts which are not futures contracts.

Neither the TPA nor the Crimes Act contain any provision which prohibits frontrunning. This creates a regulatory gap as sections 844 and 1258 of the Corporations Law are inadequate to prohibit frontrunning in the OTC derivatives markets. As seen above, section 844 applies only to securities transactions traded on exchange and is inapplicable to OTC derivatives. Section 1258 has limited application

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[14] Currie, JS, note 11, 237.
[15] Carley, J, 'The Future of Frontrunning', 13 *Company and Securities Law Journal*, 1995, 434..
[16] Carley, J, note 15, 436.
[17] Carley, J, note 15, 439.

to OTC derivatives given that it applies only to "futures contracts" and not to all derivatives contracts.

The main justification for filling the regulatory gap in relation to frontrunning is that it is akin to insider trading but in the context of the broker-client relationship.[18] It ought to be prohibited as it could cause a loss of investor confidence in the market. As Street J, observed in *Hewson* v *Sydney Stock Exchange Ltd:*[19] :

> "The primary function of a stock broker is to advise clients and to act on their behalf in the purchase and sale of shares. He occupies a position which imposes on him certain obligations towards his clients... A fundamental principle of commercial morality will be compromised if brokers are permitted to enter the market and to trade not for the clients but in competition with them."

Additionally, legislating against frontrunning may be supported on the following grounds:

(a) the broker has breached its fiduciary obligation to its client in using information which came through the client;

(b) the broker has misappropriated knowledge of its client's order for its own gain; and

(c) the broker gained unfair advantage over other market players who traded without the special knowledge of the client's order.[20]

6.2.3 *Insider dealing or trading (sections 232(5), 1002G, 1013, 1253 and 1254 of the Corporations Law)*

"Insider trading" in the securities market is made a statutory offence under sections 1002G and 1013 of the Corporations Law while "insider dealing" offences are created in sections 1253 and 1254 of the Corporations Law for the futures market. Section 1002G(2) is directed at an "insider" who possesses information that a reasonable person would expect to have a material effect on the price or value of the securities had the information been generally available. Such an insider is prohibited from subscribing, purchasing or selling securities in the body corporate in respect of which he or she possesses the price sensitive information. Similarly, a person with inside information of a futures contract is prohibited by section 1253 from dealing in the futures contract concerning a body corporate if that insider has been, at any time

[18] Carley, J, note 15, 436.
[19] (1968) 2 NSWR 224 at 231.
[20] Carley, J, note 15, 436.

during the preceding six months, connected with the body corporate. The prohibition is extended by section 1254 to the body corporate of which the insider is an officer. These offences involve the purchase or sale by persons who possess price sensitive information - which is not generally known to the investing public - about a particular securities or futures contracts. Subsection 232(5) of the Corporations Law is more specific and is directed at corporate officers and employees. It forbids them from making improper use of inside information to profit themselves.

It is submitted that these provisions are inadequate to protect investors in that they do not cover all derivatives contracts. Sections 1002G and 1013 apply only to a person trading in securities and sections 1253 and 1254 to trading in futures contracts. They have no effect on OTC derivatives contracts which are not regulated by Chapters 7 or 8 of the Corporations Law. Subsection 232(5), although potentially applicable to all derivatives contracts, provides limited protection to investors as it applies only to a limited class of offenders, namely, officers or employees of a corporation. To the extent that these provisions do not cover all derivatives contracts or all classes of "offenders", a regulatory gap exists in the Corporations Law.

Nor can the criminal and consumer laws be relied upon to provide investors with protection. Insider trading or dealing is not misleading or deceptive conduct within the meaning of section 52 TPA. It is also not a false or misleading representation under section 53 TPA. Section 51AB TPA[21] which applies to unconscionable conduct might be thought to be relevant but section 51AB is unlikely to offer much protection to investors buying or selling derivatives products in view of the restriction placed on its application. It is a requirement of subsection 51AB(1) that the unconscionable conduct must be in relation to the supply or possible supply of goods or services. Subsection 51AB(5) provides that the goods or service must be "of a kind ordinarily acquired for personal, domestic or household use or consumption." This limitation on the section would exclude all forms of securities based derivatives product and also "forward-based" products as it is difficult to see how a forward contract, even if it is for a household item such as wheat, could be said to be acquired for personal, domestic or household use or consumption.[22]

In relation to the Crimes Act, insider trading does not fall within subsection 178BA(1) (obtaining money by deception), section 178BB (obtaining money, etc by false or

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[21] Subsection 51AB(1) provides that: "A corporation shall not, in trade or commerce, in connection with the supply or possible supply of goods or services to a person, engage in conduct that is, in all the circumstances, unconscionable".

[22] Futures contracts on commodities cover large quantities of the commodity, not for domestic consumption.

misleading statement) and section 185A (inducing persons to enter into certain arrangements by misleading etc statements).

There is therefore a regulatory gap in the sanctions regime with regard to insider trading. Investors are not protected unless the contract is a securities or a futures contract. Insider trading is a serious market offence and the general view[23] is that it should be prohibited despite some arguments[24] to the contrary. Insider trading creates unfairness in that those who have inside knowledge are given an advantage over investors who do not have the information. This unfairness was well explained in the following passage in *Australian Corporations Law: Principles and Practice* using the poker player analogy:

> "(Insider trading) is like playing poker with knowledge of the way the cards will be dealt... To allow those with knowledge of confidential information to exploit ignorance of the market would be equivalent to turning a blind eye to the poker player who exploits knowledge of the way in which the deck is stacked. (footnote omitted) ... The greater number of poker players with knowledge of the deck, the thinner the ranks of actual and potential poker players is likely to be. The perceived odds would see to that. So it is with the capital markets. An apparently fair market should attract a greater number of participants than one where a significant number of players are believed to have a material advantage."[25]

More than unfairness, the above analogy shows that insider trading could dent investor confidence in the markets. Apart from these justifications, regulating against insider trading has been advocated on the grounds that it reinforces the fiduciary obligations of company officers.[26] Company officers owe both a common law as well as a statutory duty[27] to the company and it would be improper for them to take advantage of the shareholders by buying shares from them.

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[23] Campbell, D, 'Note: What is Wrong With Insider Trading', 16 *Legal Studies*, 1996, 185; Hambrook, JP, 'Liability for Misconduct in Securities Transaction' in *Australian Corporations Law: Principles and Practice*, Vol 2, Butterworths, 1991, 73,144; Baxt, R, et al., *Stock Markets and the Securities Industry - Law and Practice*, Butterworths, Sydney, 1988, 228.
[24] See Hambrook, JP, note 23, 73,144; Baxt, R, et al., note 23, 228. Baxt, R, referred to the argument in Manne, H, *Insider Trading and the Stock Market*, New York Free Press, 1966 and in Committee of Inquiry into the Australian Financial System, *Australian Financial System: Final Report of the Committee of Inquiry*, Australian Government Publishing Service, Canberra, 1981.
[25] Hambrook, JP, note 23, 73,144.
[26] Baxt, R, et al., note 23, 294.
[27] Section 232 of the Corporations Law.

A related theory is the "misappropriation theory" which holds that confidential information acquired by company directors and officers by virtue of their position with the company is the "property" of the company,[28] As such, officers are not in a position to utilise the information. It has been suggested that a fiduciary-type of relationship exists in situations where it is reasonable for one party to place special trust and confidence in the other.[29] Such an extension of fiduciary obligations would cover a professional adviser and may be justified on the basis that the adviser "occupies a position which imposes on him certain obligations towards his clients."[30]

6.2.4 Hawking (section 1078)

Hawking or the practice of going from place to place to invite subscription or to offer shares or other securities to potential buyers, is prohibited under section 1078. There is no equivalent provision which forbids the hawking of futures contracts under the sanctions provisions in Part 8.7 Division 2 of the Corporations Law.

As hawking is not conduct which involves moral turpitude, it is not an illegal activity under the Crimes Act. It is also not an activity which is outlawed by the TPA because it does not constitute misleading or deceptive conduct under section 52 or false or misleading representation under section 53 TPA and for the reason given in paragraph 6.2.3, it does not constitute unconscionable conduct under section 51AB TPA. Thus, it is to be concluded that such government regulations, as they presently exist, are grossly inadequate to protect investors from aggressive selling techniques if they are used in the OTC derivatives markets.

6.3 Manipulative conduct

Manipulative conduct is potentially the single most important abuse in the OTC derivatives market.[31] It is not surprising, therefore, that the sanctions regime in the Corporations Law is concerned with manipulative practices which have detrimental effect on investors. These manipulative practices include market manipulation (such as corners and squeezes) which are prohibited under sections 997 and 1259; fraudulently inducing dealings (such as churning) which is outlawed under sections 1000 and 1262; provision of false or misleading statements which is proscribed under sections 999 and

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[28] Baxt, R, et al., note 23, 294 - 95; see also Hambrook, JP, note 23, 73,147, f/n 30 citing *Boardman v Phipps* (1967) AC 46 where the House of Lords had apparently treated information as "property".
[29] Hambrook, JP, note 23, 73,146.
[30] Per Street J in *Hewson v Sydney Stock Exchange Ltd* (1968) 2 NSWR 224 at 231 in the context of a stock broker competing with his clients but the remarks are just as applicable to insider trading by professional advisers.
[31] Gunningham, N, note 12, 821.

1261 and false trading and market rigging (eg. wash sales and matched orders) which is prohibited under sections 998 and 1260.

6.3.1 *Market manipulation (sections 997 and 1259 of the Corporations Law)*

It has been suggested that manipulation of prices is potentially the most important abuse which confronts the futures markets.[32] In the context of the securities markets both manipulation and fraud have been known to exist for a long time, as the discussion below on selected cases shows. Stock market manipulation is prohibited by section 997 while manipulation of the futures market is proscribed by section 1259. These sections seek to prevent the creation of false prices.

Section 997 forbids a person from entering into or carrying out, either directly or indirectly, two or more transactions in securities of a company if those transactions have or are likely to have the effect of increasing, reducing or maintaining the price of securities of that company on a stock market, with intention to induce other persons to sell, buy or subscribe for the securities of the company or a related company.

Section 1259 contains a similar prohibition in relation to futures contracts. It provides that a person must not take part or be concerned in one or more transactions (whether involving in futures contract or not) if the transactions have, are intended to have or are likely to have the effect of creating an artificial price for dealings in futures contracts on a futures market or maintaining at a level that is artificial, a price for dealing in futures contracts on a futures market.

6.3.1.1 Examples of undesirable market conduct

The provisions in sections 997 and 1259 of the Corporations Law cover a number of known market practices, all of which involve manipulation by the creation of an artificial price for the securities or the futures contracts. The techniques used by traders in pushing up or down or maintaining the prices against the normal forces of supply and demand include:

(a) Corners

In relation to the securities market, "corners" is a term used to describe a situation whereby a speculator attempts to monopolise a particular listed stock ("target stock") on the exchange by buying more than the available supply of that target stock. A corner may be successfully engineered where short sellers

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[32] Gunningham, N, 'Futures Market Regulations in Australia - Part I', 66 *The Australian Law Journal*, 1992, 59 at 60.

are involved and where the target stock has a small issued capital base.[33] In this scenario, the speculator will hold off selling until an abnormally high price is reached, forcing the short sellers into a corner.[34]

As with the stock market, the futures market is susceptible to cornering in a situation where one or more speculators, who hold long positions[35] on futures contracts ("longs") in excess of the amount of that commodity, monopolise a cash commodity. The monopoly by the longs means that those who hold short positions[36] ("shorts") are unable to get the cash commodity to deliver on their contracts forcing them to buy from the longs at a price that is dictated by the longs.[37]

(b) Squeezes

A "squeeze" is similar to a corner except that the scarcity of the cash commodity or for that matter, of a particular stock, is not due to the manipulation of the speculators but, in the case of futures contracts, factors such as floods, drought or other causes[38] and in the case of securities, a pre-existing condition such as the pledge of a substantial stake in the target stock by controlling shareholders, making it possible for exploitation by the longs or speculators to hold out for a high price.

(c) Churning

"Churning" occurs where, for example, a dealer who has control or discretion over a client's account induces excessive and frequent transactions in the client's account so as to benefit itself.[39]

These practices, involving as they do manipulation of prices for gain at the expense of other investors in the market call into question the conscionability of such transactions. Parallels exist between sections 997 and 1259 of the Corporations Law and the misuse of market power and unconscionable conduct provisions in the TPA. These are examined below.

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[33] Baxt, R, et al., note 23, 223.

[34] Wood, PR, *International Loans, Bonds and Securities Regulation,* Sweet & Maxwell, London, 1995, 223.

[35] A person holding a long position has more purchases in a commodity or currency than sales, giving that person a positive asset position in that commodity or currency.

[36] A person is said to hold a short position if that person has more sales contracts than bought contracts. This is the opposite of a long position.

[37] *Cargill Inc. v Hardin*, 452 F.2d 1154, at 162 (8th Circuit 1971) cited by Currie, JS, note 11, 223. *Australian Futures Regulation,* Longman Professional, Melbourne, 1994, 223.

[38] Currie, JS, note 11, 223.

[39] Wood, PR, note 34, 349; Baxt, R, et al., note 23, 222.

6.3.1.2 Applicability of TPA

The provisions of particular relevance are sections 45 TPA (arrangements affecting dealings or competition), 45A TPA (arrangements in relation to prices), 46 TPA (misuse of market power) and 50 TPA (prohibition of acquisitions that would result in a substantial lessening of competition) in Part IV, section 51AB TPA (unconscionable conduct) in Part IVA and sections 52 TPA (misleading or deceptive conduct) .

Analysis of sections 45(2) TPA (arrangements affecting dealings or competition)

The material part of subsection 45(2) TPA provides as follows:

> "A corporation shall not -
>
> (a) make a contract or arrangement or arrive at an understanding, if -
>
> (i) ...
>
> (ii) a provision of the proposed contract, arrangement or understanding has the purpose, or ... have the effect, of substantially lessening competition; ..."

This subsection of the TPA is applicable to conduct which has or is likely to have an anti-competitive effect in a market.[40] In that respect it echoes section 997 and section 1259 of the Corporations Law which seek to prevent the creation of false prices, including the creation of false prices by reducing competition in the market using manoeuvres such as corners (discussed above). The question as to whether corners would be prohibited by subsection 45(2) TPA can be answered by determining if they satisfy the following criteria:

(a) they (that is, corners) require the making of a contract, arrangement or understanding; and

(b) the contract, arrangement or understanding has the purpose or effect of substantially lessening competition.

In relation to the criterion in paragraph (a), although "arrangement" has not been defined in the TPA, the courts have done so. One definition of this term which has found favour in Australian courts[41] was provided by Diplock LJ in the English case of *Re British Basic Slag Ltd Agreements.*[42] as follows:

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[40] Steinwall, R & Layton LP, *Trade Practices Act,* Butterworths, Sydney, 1995, 59.

[41] *Trade Practices Commission v Nicholas Enterprises Pty Ltd* (No 2) (1978) 40 FLR 83; *Trade Practices Commission v Email Ltd* (1980) 31 ALR 53; *Top Performance Motors Pty Ltd v Ira Berk (Qld) Pty Ltd* (1975) 24 FLR 286; ATPR 40-004.

[42] (1963) 1 WLR 727.

> "(Arrangement) involves a meeting of minds ... because it has to be between 'two or more persons' and ...it involves mutuality in that each party assuming he is a reasonable and conscientious man, would regard himself as being in some degree under a duty whether moral or legal to conduct himself in a particular way or not to conduct himself in a particular way as the case may be, at any rate so long as the other party or parties conducted themselves in the way contemplated by the arrangement."[43]

Likewise, "understanding" is not a defined term but was explained by Smithers J in *Top Performance Motors Pty Ltd v Ira Berk (Qld) Pty Ltd*[44] as involving "the meeting of two or more minds."[45]

These cases clearly establish that both "arrangement" and "understanding" requires more than one person and it is therefore a pre-requisite to the application of subsection 45(2) TPA that there must be two or more persons involved. Certainly, one person cannot enter into a contract or make an arrangement or have an understanding with himself or herself. Corners are practices which theoretically may be executed by a single operator and to the extent that this is so, subsection 45(2) TPA would be inapplicable. However, it is recognised that in practice, situations involving a single manipulator are possibly rare in view of the tremendous financial resources required to buy up sufficient number of the target stock or futures contracts so as to be in a position to control the price levels. For practical purposes, the criterion in paragraph (a) is satisfied in the majority of situations contemplated by sections 997 and 1259 of the Corporations Law.

In relation to the criterion in paragraph (b), this would appear to be met as the success of corners depends on the longs holding a position of monopoly. In other words, the aim of the manoeuvre is to substantially lessen, if not to eliminate, competition so that the manipulators would be in a position to control or maintain the price for the supply of the target stock or the futures contracts. Where a contract, arrangement or understanding is made between or among competitors, section 45A TPA deems a provision of such a contract, arrangement or understanding to have the purpose or effect of substantially lessening competition if it has the purpose or effect or likely effect of fixing,[46] controlling or maintaining[47] the price for the supply of goods to be supplied by the parties to the contract or arrangement.[48]

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[43] At 746. See Duns, J & Davidson, MJ, *Trade Practice and Consumer Protection: Cases and Materials*, Butterworths, Adelaide, 1994, 191; Steinwall, R & Layton LP, note 40, 60.
[44] (1975) 24 FLR 286; ATPR 40-004.
[45] At 17,116, excerpts of which were reproduced Steinwall, R & Layton LP, note 40, 61.
[46] The phrase "fixing, controlling or maintaining" was the subject of interpretation by the court in

The effect of section 45A is to render price fixing unlawful per se.[49] If the parties to the arrangement are not in competition with each other, as they are unlikely to be in a corner,[50] section 45A can have no application but an arrangement may still contravene subsection 45(2) TPA so long as it meets the two criteria set out in (a) and (b) above.

It is to be concluded that the typical manipulative strategies (for example, corners) prohibited by sections 997 and 1259 of the Corporations Law would also be covered by subsection 45(2) TPA except in situations where the offence is committed by a single person.

Analysis of section 46 TPA (misuse of market power)

Section 46 prohibits a corporation with a substantial degree of market power from taking advantage of that power to eliminate or substantially damage a competitor or a related corporation of the competitor; prevent the entry of a person into that or any other market; or deter or prevent a person from engaging in competitive conduct in that or any other market.

Three requirements must be satisfied for section 46 TPA to apply. These are:

(1) a threshold test for market power, that is, the corporation must have a substantial degree of power in a market;

(2) the corporation takes advantage of that substantial power; and

(3) the purpose for which the market power has been used is in relation to one or more of the conduct specified in paragraph 46(1)(a),(b) or (c) TPA, which is, to eliminate or substantially damage a competitor or a related corporation of

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Radio 2UE Sydney Pty Ltd v Stereo FM Pty Ltd (1982) 62 FLR 437. Lockhart J who delivered the written judgement of the court said, in relation to "fixing" that "the fixing of a price for the purpose of section 45A does not necessary connote an element of permanency, but generally suggests the settling or determining of a price for a period of time that is not instantaneous or merely ephemeral." To Lockhart J's interpretation, the court in *Radio 2UE Sydney Pty Ltd v Stereo FM Pty Ltd* (1983) 68 FLR 70, which heard the appeal on Lockhart J's decision, has this to add:

"There must, we believe, be an element of intention or likelihood to affect price competition before price "fixing" can be established. This will often be a matter of inference, requiring no direct evidence for it to be established."

[47] Concerning the term "maintaining" Lockhart J in *Radio 2UE Sydney Pty Ltd* (1982), note 46, 437opined that:

"In my view 'maintain', where used in s 45A, has a similar connotation to the verb 'fix' in that it involves some element of continuity, not merely being momentary or transitory. Generally to maintain a price assumes that it has been fixed beforehand."

[48] Steinwall, R & Layton LP, note 40, 66.

[49] Per Lockhart J in *Radio 2UE Sydney Pty Ltd* (1982) note 46, 437.

[50] The reverse is probably the case for comers as the parties engaged in effecting a corner would likely to be associates acting in concert.

the competitor; prevent the entry of a person into that or any other market; or deter or prevent a person from engaging in competitive conduct in that or any other market.[51]

Like section 45 TPA, section 46 may be equated with sections 997 and 1259 of the Corporations Law in view of its anti-competitive element. A corporation which already commands substantial power in the market, as for example, it is the holding company of a listed company, would be prevented by section 46 TPA from effecting a "squeeze" assuming that the conditions conducive to such an exercise, including the existence of short sellers in the market, are present. A holding company which makes use of its dominant position in the market in respect of its listed subsidiary's shares would be taking advantage of its market power to substantially damage a competitor. The term "competitor"[52] as defined in subsection 46(1A) TPA would arguably include any shortseller who needs to cover its position and who, it is submitted, arguably (but by no means certain) could be a competitor in the context of the purchase of the shares of the subsidiary.

Analysis of Section 50 TPA (prohibition of acquisitions that would result in a substantial lessening of competition)

Yet another anti-competitive provision which possibly could be used against market manipulators is section 50 TPA. It proscribes the acquisition of shares or assets of any person by a corporation if the acquisition will have the effect, or be likely to have the effect of substantially lessening competition in the market. The matters which may be taken into account in determining whether an acquisition would have the effect or likely effect of substantially lessening competition in a market would include the level of concentration in the market and the likelihood that the acquisition would result in the acquirer being able to significantly and sustainably increase prices or profit margins.[53]

The prohibition in section 50 TPA suggests a similarity with section 997 of the Corporations Law (manipulation of the securities market) and section 1259 of the Corporations Law (manipulation of the futures market) which are directed at the creation of false prices. To recapitulate, sections 997 and 1259 seek to prevent the creation of false prices and prohibit a person from trading in securities or futures

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[51] See Duns, J & Davidson, MJ, note 43, 134.

[52] Subsection 46(1A) TPA defines a "competitor" to include "a reference to competitors generally, or to a particular class or classes of competitors." This means that the conduct need not be identified with a known party.

[53] Subsection 50(3) TPA.

contracts if those transaction or transactions have or are likely to have the effect of increasing the price of securities of that company on a stock market or creating an artificial price for dealings in futures contracts on a futures market. Prima facie, a corner - being an exercise undertaken by the acquirer with the objective of enabling the acquirer to significantly and, it may be argued, sustainably[54] increase prices or profit margins - would have the effect, or be likely to have the effect of substantially lessening competition in the market. A manipulator who wishes to achieve a corner will need to buy into the target stock or futures contract. In fact, it is essential to his or her success that the manipulator acquires more than the available supply of that target stock or hold long positions on futures contracts in excess of the amount of that commodity, thus eliminating competition by achieving a position of virtual or near monopoly. Such an acquisition would clearly be prohibited by section 50 TPA.

Whilst it is conceivable that prices may be manipulated otherwise than by using corners or squeeze (if opportunity arises), the known methods of market manipulations comprise of anti competitive strategy (for example, corners) and it is to be concluded that section 50 TPA would be an adequate alternative for the offences envisaged by section 997 and section 1259 of the Corporations Law.

Analysis of section 51AB TPA (unconscionable conduct)

Section 51AB TPA[55] prohibits unconscionable conduct on the part of a corporation in relation to the supply or possible supply of goods and as such would have the potential to prohibit manipulative fraudulent or misleading conduct in the securities and futures markets. Subsection 51AB(1) provides that:

> "A corporation shall not, in trade or commerce, in connection with the supply or possible supply of goods or services to a person, engage in conduct that is, in all the circumstances, unconscionable."

The key elements in this subsection are: (a) supply or possible supply of goods or services; and (b) unconscionable conduct.

The term "unconscionable" is not a defined term, although subsection 51AB(2) provides the court with guidelines as to the matters it may take into account in arriving at a decision as to whether unconscionable conduct exists. The matters specified in subsection 51AB(2) include unfair tactics, pressure, undue influence and the relative

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54 The acquirer will be in a position to sustain artificially high prices until the requirements of the shortsellers are satisfied.

55 In NSW, the provisions of *Contracts Review Act 1980* are also relevant to unconscionable conduct.

strengths of the bargaining positions of the corporation and the consumer. In respect of the criterion of unconscionability, it is submitted that most (if not all) manipulative, misleading or fraudulent conduct which is proscribed by Chapters 7 and 8 of the Corporations Law would fall within the plain and ordinary meaning of unconscionable conduct.

As noted in paragraph 6.2.3 above, section 51AB TPA is unlikely to offer much protection to investors buying or selling derivatives products in view of the requirement that the supply or possible supply of goods or services must be "of a kind ordinarily acquired for personal, domestic or household use or consumption".

For practical purposes section 51AB TPA will have little, if any, application in prohibiting malpractices in the OTC markets.

Analysis of section 52 TPA (misleading and unconscionable conduct)

The crux of the issue is whether the manipulation of a securities or futures market, in the manner proscribed by sections 997 and 1259 of the Corporations Law, could constitute misleading or deceptive conduct under section 52 TPA. The gravamen of the offence in both sections 997 and 1259 is the entering into transactions to buy or sell a securities or futures contract with the intention to induce other persons to buy or sell the securities of a particular company or futures contracts. The entering into transactions would be doing an act within the meaning of "engaging in conduct" as defined in subsection 4(2) TPA. To contravene sections 997 and 1259, it would also be necessary for that act (that is, the entering into transactions) to be accompanied by the requisite mens rea. If such acts are deliberately carried out in the market to provide a misleading appearance of a particular price so as to induce others to buy or sell, they would be misleading behaviour and would constitute misleading or deceptive conduct in section 52 TPA. However, in relation to corners and squeezes, the conduct involved in these manoeuvres would not appear to be misleading or deceptive, according to the tests formulated by the full Federal Court in *Taco Company of Australia Inc. & Anor* v *Taco Bell Pty Ltd & Ors.*[56] (Taco's tests).[57] This is because

[56] (1982) ATPR, 40-303 at 43,751-43,752.

[57] The tests (Taco's tests) formulated by the Court to determine whether a conduct is within section 52 TPA may be summarised as follows:

- Identify the relevant section of the public by reference to whom the question of whether conduct is or likely to be misleading or deceptive falls to be tested;
- Consider the conduct by reference to all those who come within it, including the astute and the gullible;
- Determine if some person has in fact formed an erroneous conclusion. Such evidence is indicative but does not of itself establish that the conduct is misleading or deceptive; and
- Inquire why proven misconception has arisen in order to evaluate they are confused because of misleading or deceptive conduct on the part of the "offender".

the section of the public who would be affected by the manipulator's conduct are the shortsellers and as they are presumably already in the market[58] they cannot be said to be confused because of misleading or deceptive conduct on the part of the manipulator. The offensive conduct is nothing more than purchasing large quantities of the target stock or futures contracts and holding off selling to the short sellers (who would be desperate to buy to cover their positions) until an artificially high price is reached. Although such conduct is morally repugnant, it is neither misleading nor deceptive. Therefore, section 52 TPA is not a viable alternative to sections 997 and 1259 of the Corporations Law.

6.3.1.3 Applicability of the Crimes Act

There is no provision in the Crimes Act which could be used in place of sections 997 or 1259 of the Corporations Law in relation to the offences of "corners" and "squeezes" although arguably subsection 178BA(1) of the Crimes Act may apply to "churning". As the analysis in this paragraph shows, subsection 178BA(1) may not an effective substitute to sections 997 or 1259 of the Corporations Law, except perhaps in relation to churning.

It may be recalled that sections 997 and 1259 prohibit a person from entering into or carrying out, either directly or indirectly, two or more transactions (in the case of securities) or one or more transactions (in relation to futures contract with the intention, in the case of section 997 of the Corporations Law of inducing other persons to sell, buy or subscribe for the securities of the company or a related company or, in the case of section 1259 of the Corporations Law, of creating an artificial price for dealings in futures contracts on a futures market or maintaining at a level that is artificial, a price for dealing in futures contracts on a futures market.

One of the key elements of the offence in subsection 178BA(1) of the Crimes Act is deception. "Deception", as defined in subsection 178BA(2), is deliberate or reckless deception by words or conduct as to fact or as to law. It is the intentional inducing in another of a state of mind which the offender knows does not reflect the true situation.[59] It is arguable that the act of entering into one or more transactions for the purpose of creating an artificial price, in the context of sections 997 and 1259 of the Corporations Law, is not "deception" within the meaning of subsection 178BA(2) of the Crimes Act, as such an act is not intended to deceive the "shortsellers". In fact,

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[58] Manipulators generally enter the market if opportunity arises and one such opportunity is where shortsellers are present.

[59] *Corporate Affairs Commission* v *Papoulias (1989)* 20 NSWLR 503 at 506, cited in Watson, R, Blackmore AM & Hosking, GS, *Criminal Law (NSW)*, Vol 1, LBC Information Services, Sydney, 1996, 1-1802.

and as noted above in relation to corners and squeezes, shortsellers are already in the market when the transactions are being entered into and these shortsellers cannot therefore be said to be "deceived".

"Churning" however, may involve deceit. A broker who indulges in "churning" by inducing excessive and frequent transactions in the client's account so as to benefit itself would have carried out transactions which, had the client been made aware, would not have been allowed. As such, the broker's acts are likely to be carried out in a clandestine manner which would be an act of deliberate deception.

The other two elements of the offence in section 178BA(1) of the Crimes Act concern dishonesty and money. It is submitted that "dishonesty" is present in churning because, as discussed in the preceding paragraph, it would likely involve deliberate deception. It has been said that deliberate deception is one of the two most obvious forms of dishonesty.[60] As regards the third element, ie money, that again is satisfied as financial gain is the objective of churning. These three element being likely to be present, it is suggested that subsection 178BA(1) of the Crimes Act has the potential to catch churning which is proscribed by section 1259 of the Corporations Law.

Subsection 178BA(1) of the Crimes Act does not have the capacity to prohibit corners and squeezes although it may be an alternative remedy to section 1259 of the Corporations Law to punish offenders conducting churning exercises on their clients accounts.

6.3.2 False trading and market rigging (sections 998 and 1260)

False trading is a form of market manipulation, and so is market rigging. These practices are designed to generate a false impression so that others may believe that there is a genuine demand for a commodity or security.[61] Such conduct is prohibited by sections 998[62] and 1260[63] of the Corporations Law.

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[60] *R* v *Ghosh* (1982) QB 1053 at 1060.

[61] Baxt, R, et al., note 23, 223.

[62] This provides that:

"(1) A person shall not create, or do anything that is intended or likely to create, a false or misleading appearance of active trading in any securities on a stock market or a false or misleading appearance with respect to the market for, or the price of, any securities; ...

(3) A person shall not, by means of purchases or sales of any securities that do not involve a change in beneficial ownership of those securities or by any fictitious transactions or devices, maintain, inflate, depress, or cause fluctuations in, the market price of any securities."

[63] Section 1260 mirrors section 998 and it provides, in relation to the futures markets, as follows:

"(1) A person must not, ... create, caused to be created, or do anything that is calculated to create, a false or misleading appearance:

(a) of active dealing in futures contracts on a futures market ...; or

(b) with respect to the market for, or the price for dealings in, futures contracts on a

6.3.2.1 Examples of undesirable market conduct

The offences provisions in sections 998 and 1260 of the Corporations Law are drafted in very wide terms It refers to the creation of a false market by a variety of manipulative devices. Common methods in the securities market include:

(a) Wash sales

This is essentially a sale of securities or a commodity by a person to himself or herself. The transaction does not involve a change in the beneficial ownership of the subject matter of the sale.[64]. Wash sales is also a practice which could take place in the futures market with the simultaneous sale and purchase of a futures contract by the same person.[65] It is intended to foster the appearance of an active market in the hope of influencing others to purchase the securities or futures contracts.

The harm which washed sales could cause was explained by McLennan JA in *R v Macmillan*:[66]

> "To the extent that the economy of the country is based upon enterprises requiring capital and therefore the free trading in securities, it is of utmost importance that public confidence be maintained in the integrity of trading on the stock exchange, which are in one sense public utilities, and also that a similar confidence be maintained in the financial community serving that phase of economic life. Wash trading inevitably adversely affects such public confidence".[67]

(b) Matched orders

A "matched order" involves a person placing buy and sell orders simultaneously for substantially the same number of securities[68] or futures contracts and at substantially the same price. Such a practice is a false trading which creates a misleading impression in the minds of members of the public

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futures market ...

(2) A person must not, ... by any fictitious or artificial transactions or devices, maintain, inflate, depress, or cause fluctuations in, the price for dealings in futures contracts on a futures market..."

64 Hambrook, JP, note 23, 73,121.

65 Currie, JS, note 11, 229.

66 (1968) 66 DLR (2d) 680, CA(Ontario) at 686.

67 Quoted by Hambrook, JP, note 23, 73,123, f/n 20.

68 Hambrook, JP, note 23, 73,121.

that particular securities or futures contracts are actively traded because they are in real demand.

The likely motive for "wash sales" and "matched orders" (or sometimes called "matched sales") is to generate sufficient interest in the securities or futures contract so as to increase its price.[69]

(c) Pools

Another possible fraudulent device is pools. The term "pools" is given to a practice whereby a number of persons or companies, say five or six of them, agree to put up a substantial pool of funds with the intention of boosting the turnover of a particular stock which pool members have earmarked as a target. The funds in the pool are used to purchase the target stock and then sold successively from one member to another, usually through a broker, thus giving the impression of an increased turnover. The aim is to raise the price of the target stock and provide the members with the opportunity of selling their shares at a profit.[70]

The deeming provision in paragraph 998(5)(a) of the Corporations Law as to what constitutes "a false or misleading appearance of active trading" appears to cover washed sales while paragraphs 998(5)(b) or (c) would cover matched orders.[71] The scope of subsections 998(1) and 1260(1) is broad and goes beyond washed sales or matched orders. These subsections are aimed at prohibiting the creation of a false or misleading appearance of active trading in securities or futures contracts or of the market or of the price of particular securities or futures contracts. It is submitted that they would prohibit pools. The legislative intent of section 70 of the *Securities Industry Act 1970* (NSW) which is similar in content to subsection 998(1) .was explained by Mason J in the High Court decision of *North and Others Trading as J&J North* v *Marra Developments Ltd*[72] thus:

> "It seems to me that the object of the section is to protect the market for securities against activities which will result in artificial or managed manipulation. The section seeks to ensure that the market reflects the forces of genuine supply and demand. By 'genuine supply and demand' I exclude buyers and sellers whose transactions are undertaken for the sole or primary purpose

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69 Hambrook, JP, note 23, 73,121.
70 Baxt, R, et al., note 23, 222.
71 Hambrook, JP, note 23, 73,122.
72 (1982) 56 ALJR 106, at 112 quoted by Baxt, R, et al., note 23, 224.

of setting or maintaining the market price. It is in the interest of the community that the market for securities should be real and genuine, free from manipulation. The section is a legislative measure designed to ensure such a market ..."

The above practices, involving the manipulation of prices by fictitious or artificial transactions or devices at the expense of other investors in the market, are proscribed by sections 998 and 1260 of the Corporations Law. Arguably, these practices are covered under the misleading and deceptive conduct provision in section 52 TPA.

6.3.2.2 Applicability of TPA

Subsections 998(1) and 1260(1) of the Corporations Law prohibit a person from creating a false or misleading appearance of active trading in any securities or futures contracts on organised markets or with respect to the price of any securities or futures contracts. Additionally subsections 998(3) and 1260(2) of the Corporations Law forbid the use of fictitious or artificial transactions or devices to maintain, inflate, depress, or cause fluctuations in, the price for dealings in securities or futures contracts.

Section 52 TPA has the potential to be used against offenders who are in breach of sections 998 and 1260 of the Corporations Law if those offenders "engage in conduct that is misleading or deceptive." A requirement of the offence provisions is that a person must be shown to have "created" a false or misleading appearance of active trading (in subsections 998(1) and 1260(1)) or to have "maintained", "increased" or "reduced" the market price of securities or futures contracts by fictitious or artificial transactions or devices (in subsections 998(3) and 1260(2)). The actions contemplated would constitute the doing of an act within the meaning of "engaging in conduct" as defined in subsection 4(2) TPA.

It is submitted that the second requirement of the offences, namely, creating "a false or misleading appearance" of active trading in respect of subsections 998(1) and 1260(1) of the Corporations Law or maintaining, increasing or reducing market prices by "fictitious or artificial transactions or devices" in respect of subsections 998(3) and 1260(2) of the Corporations Law, would be "misleading" within the meaning of section 52 TPA. This conclusion is reached on the basis that the conduct complained of in subsections 998(1) and 1260(1) by prescription in those subsections must be "misleading". As regards subsections 998(3) and 1260(2), the use of "fictitious or artificial transactions or devices" by the offender would be conduct that is misleading or deceptive. This conclusion is supported by the dicta of Stephen J who commented

in *Hornsby Building Information Centre Pty Ltd & Anor* v *Sydney Building Information Centre Ltd* that "...sec. 52(1) ... is concerned with consequences as giving to particular conduct a particular colour. If the consequences is deception, that suffices to make the conduct deceptive"[73] and of Murphy J who observed in the same case that "(c)onduct is deceptive or misleading if it has a capacity or tendency to mislead or deceive; intention to mislead or deceive is not required."[74]

It would therefore appear that the conduct impugned by sections 998 and 1260 of the Corporations Law would also be proscribed under section 52 TPA.

6.3.2.3 Applicability of the Crimes Act

Subsection 178BA(1) of the Crimes Act[75] deals with obtaining money by deception and section 185A[76] of that Act prohibits a person from inducing others to enter into certain arrangements by misleading statements. These sections are examined to determine if they may be depended upon as an alternative to sections 998 and 1260 of the Corporations Law.

Analysis of subsection 178BA(1)

The elements of the offence in subsection 178BA(1) are firstly, deception; secondly, dishonestly obtaining for itself or another person; and thirdly, money or a valuable thing or financial advantage. As explained above, the definition of "deception" in subsection 178BA(2) involves the deliberate or reckless deception by words or conduct as to fact or as to law. In the cases of pools, matched orders and wash sales, there can be little doubt that such activities are carried out to deceive other investors. They constitute intentional inducing in another of a state of mind which the offender

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[73] (1978) ATPR 40-067 at 17,690.

[74] at 17,693 quoted in the Australian Trade Practices Reporter, Vol 2, CCH, 1990, 14,698-14,711.

[75] This subsection 178BA(1) provides that:

> "Whosoever by any deception dishonestly obtains for himself or another person any money or valuable thing or any financial advantage of any kind whatsoever shall be liable to imprisonment for five years."

[76] Section 185A provides that:

> "Whosoever, by any statement, promise, forecast which he knows to be misleading, false or deceptive, or by any dishonest concealment of material facts, or by reckless making (dishonestly or otherwise) of any statement, promise or forecast which is misleading, false or deceptive, induces or attempts to induce another person to take part or offer to take part in any arrangement with respect to property other than marketable securities, being arrangements the purpose or effect or pretended purpose or effect, of which is to enable persons taking part in arrangements (whether by becoming owners of the property or any part of the property or otherwise) to participate in or receive profits or income alleged to arise or to be likely to arise from the acquisition, holding, management or disposal of such property, or sums to be paid or alleged to be likely to be paid out of such profits or income, shall be liable to penal servitude for five years."

knows does not reflect the true situation.[77] "Dishonesty" is not difficult to establish either as these practices would involve deliberate deception and deliberate deception is an obvious form of dishonesty. As regards the third element, ie money, that again poses no difficulty as financial gain is the objective of the manipulative exercises. These three element being likely to be present, it is suggested that subsection 178BA(1) has the potential to catch those malpractices proscribed by sections 998 and 1260 of the Corporations Law.

<u>Analysis of subsection 185A</u>

Section 185A (inducing persons to enter into certain arrangements by misleading etc statements) comprises the following key elements:

1. the making of any statement, promise, forecast; and
2. (a) the knowledge that such statement is misleading, false or deceptive; or
   (b) dishonest concealment of material facts; or
   (c) the reckless making (dishonestly or otherwise) of any statement, promise or forecast which is misleading, false or deceptive; and
3. inducing or attempting to induce another person to take part or offer to take part in any arrangement with respect to property other than marketable securities.

It is submitted that this section cannot be a substitute for sections 998 and 1260 of the Corporations Law as section 185A is directed at dissemination of false statements while the offences proscribed by sections 998 and 1260 of the Corporations Law involve the creation of a false market, which can be done only by trading on the market (and not by the spreading of statements or information).

Section 185A of the Crimes Act is not a suitable replacement for sections 998 or 1260 of the Corporations Law.

6.3.3 False or misleading statement (sections 999, 1261)

The use of false or misleading statements as a means to manipulate the market is prohibited by section 999 and section 1261. These sections render it an offence if the following elements are satisfied:

(1) the making of a statement or the dissemination of information that is
   (i) false or misleading in a material aspect; and

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[77] *Corporate Affairs Commission v Papoulias (1989)*, note 59, 506, cited in Watson, Blackmore & Hosking, note 59, 1-1802.

(ii) likely to induce the sale or purchase of securities or induce dealings in futures contracts on a futures market by other persons; or

(iii) likely to have the effect of increasing, reducing, maintaining or stabilising the market price of securities or the price for dealings in futures contracts on a futures market; and

(2) when making the statement or disseminating the information, the person does not care if it is true or false or the person knows or ought reasonably to know that the statement is false in a material way.

These provisions are aimed at curbing the spreading of false rumours either (a) with the intention of depressing the price of securities or a commodity so that the rumour monger could buy the securities or commodity at depressed prices or (b) with the intention of raising the market prices so that he or she may unload securities or futures contracts at abnormally high prices. The use of false or misleading statements for gain has been known to exist since the early 1300s. One of the earliest reported English case was *Anon*[78] in which a foreigner spread a false rumour about a market glut of wool overseas, with the intention that the market price for wool should fall. This was held to be a crime.[79] In *R v De Berenger*[80] De Berenger bought government bonds during the Napoleanic wars and then started a rumour that Napolean was dead and peace would be restored. The market responded positively and De Berenger was able to make a good profit.[81]

6.3.3.1 Applicability of TPA

The offences in sections 999 and 1261 of the Corporations Law involve the making or spreading of false information which, prima facie, appears to satisfy the requirement for "misleading or deceptive conduct" within the meaning of section 52 TPA.[82] The background information on section 52 TPA and its applicability to financial derivatives together with a discussion of the key terms is provided in Appendix 1 of this thesis. It is submitted that the circumstances giving rise to a breach of sections 999 or 1261 would constitute a breach of section 52. This is particularly so when, as in sections 999 and 1261, the conduct must be either reckless or intentional. Such conduct has the potential of meeting the tests[83] for misrepresentation as set out by the full Federal

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[78] *Anon* (1369) Jenk 49 (case xciii), 145 ER 36.
[79] See Wood, PR, note 34, 348.
[80] (1814) 3 M&S 67, 105 ER 536.
[81] See discussion in Wood, PR, note 34, 349; Baxt, R, et al., note 23, 220.
[82] Section 52 provides as follows:

"A corporation shall not, in trade or commerce, engage in conduct that is misleading or deceptive or which is likely to mislead or deceive."

[83] Taco's tests, note 57.

Court in *Taco Company of Australia Inc. & Anor* v *Taco Bell Pty Ltd & Ors.*[84] In conclusion, it is apparent that section 52 TPA would have the potential of protecting investors in place of sections 999 and 1261 of the Corporations Law.

6.3.3.2 Applicability of the Crimes Act

Analysis of subsection 178BA(1)

The elements of the offence in subsection 178BA(1) of the Crimes Act have been discussed above. This subsection prohibits the dishonest obtaining of any money or valuable thing or any financial advantage by deception.

A person who commits one of the acts forbidden by section 999 and section 1261 of the Corporations Law would satisfy the elements of "deception" and "dishonesty" in section 178BA of the Crimes Act as the acts contemplated by sections 999 and 1261 require mens rea, that is, that the offender is either recklessly indifferent or does not care as to the truth of the statements or that it knows that the information which it disseminates is false or misleading. The third element, the obtaining "any money or valuable thing or any financial advantage", is also met as the objective in manipulative practices is to make money.

It would appear from this analysis that subsection 178BA(1) has the potential to catch those malpractices proscribed by sections 999 and 1261 of the Corporations Law.

Analysis of section 178BB of the Crimes Act

An analysis of section 178BB of the Crimes Act indicates that the elements of this section are likely to be met. An intention to obtain money, valuable thing or financial advantage is presumably present in the offences proscribed by sections 999 and 1261 of the Corporations Law. Such an intention is inferred because it would be unlikely for an offender to spread misleading statements in the manner contemplated by sections 999 and 1261 unless it is for the offender's gain. The second and third elements in section 178BB, the act of making or publishing an oral or written statement which is false or misleading in a material particular; is again satisfied as sections 999 and 1261 are directed against the making of statements or dissemination of information that are false or misleading in a material particular. The conclusion that may be drawn from this comparison is that section 178BB of the Crimes Act provides investors with protection similar to that provided in sections 999 and 1261 of the Corporations Law.

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[84] (1982) ATPR, 40-303 at 43,751-43,752.

Analysis of section 185A of the Crimes Act

The gravamen of the offence in section 185A (inducing persons to enter into certain arrangements by misleading etc statements) has been set out in paragraph 6.3.2.3 above. This section is of limited application because a major exclusion, relevant to derivatives, is "marketable securities" which has been specifically defined in subsection 185A(6) of the Crimes Act as having the "meaning ascribed to that expression in the Companies (New South Wales) Code". This latter Act, although repealed, is nevertheless of relevance in respect of the interpretation of "marketable securities", which has been defined therein to mean "debentures, stocks, shares, or bonds of ...any corporation, association or society, and includes any right or option in respect of shares in any corporation and any prescribe interest." Thus defined, it is virtually identical to "marketable securities" in section 9 of the Corporations Law.[85] By excluding marketable securities, and thereby excluding prescribed interest, from the ambit of section 185A of the Crimes Act, it effectively rules out being a substitute for section 999 of the Corporations Law which applies only to contracts which are securities.

In relation to section 1261 of the Corporations Law, section 185A of the Crimes Act mirrors section 1261 in that the elements of the offences in both enactments are in some respects similar. Like section 185A, section 1261 requires:

1. the making of a statement or dissemination of information that is misleading or false in a material particular; and
2. the statement or information is made recklessly or made with knowledge that is misleading or false in a material particular; and
3. the statement or information induces another person to deal in a futures contract.

It is submitted that section 185A of the Crimes Act will afford investor protection similar to the protection provided under section 1261 of the Corporations Law.

6.3.4 Fraudulently inducing dealings (sections 1000 and 1262)

An often used devise for manipulating the market is the "run". The Senate Select Committee on Securities and Exchange (Rae Committee), in its report *Australian Securities Markets and their Regulation*, recounted that most witnesses who discussed manipulative activities did not refer to pools or churning but spoke of organised

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[85] Marketable securities in section 9 of the Corporations Law states that the term means "debenture, stock, shares, or bonds of ...any body corporate, association or society and includes any right or option in respect of shares in any body corporate or any prescribe interest."

runs.[86] Runs involve the creation of activity in a target stock or target futures contract by buying into the stock or futures contract or disseminating false rumours to induce others to buy, thereby generating a demand for the stock or futures contract, and consequently increasing its price. This device allows the organisers of the run to sell their holdings at inflated prices to reap quick profits.

In many cases, market manipulative practices such as runs and churning depend on dissemination of false or misleading information for their success. This is because the circulation of false information is a very cheap and effective way of creating a demand for a particular stock or futures contract compared with the alternative method of buying into the stock or futures contract (as one would do for corners). The buying into contracts in order to move the market requires substantial financial resources. Therefore, if the spreading of such information. is prohibited, manipulative practices may be discouraged.

Section 1000 (in relation to securities) and section 1262 (in relation to futures contracts) forbids a person[87] from inducing another person to deal in securities or futures contracts or a class of futures contracts by means of any dishonest concealment of material facts, the making or publishing of any statement, promise or forecast that the maker of the statement knows to be misleading, false or deceptive or the recording or storing of information which the person knows to be false or misleading in a material aspect.

Both provisions (sections1000 and 1262) are modelled on section 126 of the *Securities Industry Act 1980* (Cth) and are wider in scope than sections 1001 and 1263, discussed below, which are confined to dissemination of information on illegal market practices. The provisions in section 1000 and 1262 are directed at all persons who are preparing or publishing statements to the investing public and not only between the broker and its client.[88]

6.3.4.1 Applicability of TPA

The main element of the offences in sections 1000 and 1262 is either the dishonest concealment of material facts or the making or publishing of any statement, promise or

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[86] Baxt, R, et al., note 23, 222 - 23.

[87] It was held by Nicholsen J in *National Companies and Securities Commission v Monarch Petroleum NL and Ors* (1984) VR 733,that the identity of the person or persons who committed the offence is not important when considering whether section 126 of the *Securities Industry Act 1980* (Cth) was contravened.

[88] See Meyer, PW, 'Fraud and Manipulation in Securities Markets: A critical Analysis of s 123 - 127 Securities Industry Code', 4 *Company and Securities Law Journal*, 1986, 92 at 99 - 100.

forecast that the maker knows to be misleading, false or deceptive in a material aspect. The dishonest concealment of material facts, involving as it does the element of "dishonesty", clearly would be "deceptive" conduct under section 52 TPA and the making or publishing of any statement, promise or forecast that the maker knows to be misleading, false or deceptive would be "misleading or deceptive" conduct.[89] Therefore, section 52 TPA would appear to have the capacity to be used as an alternative to sections 1000 and 1261.

6.3.4.2 Applicability of the Crimes Act

The provisions in the Crimes Act which are of relevance are subsection 178BA(1) of the Crimes Act which deals with obtaining money by deception, section 178BB[90] (obtaining money etc by false or misleading statement) and section 185A[91] (inducing persons to enter into certain arrangements by misleading etc statements). The extent of the protection given to investors under these provisions is considered below.

Analysis of subsection 178BA(1)

Subsection 178BA(1) of the Crimes Act provides that:

> "Whosoever by any deception dishonestly obtains for himself or another person any money or valuable thing or any financial advantage of any kind whatsoever shall be liable to imprisonment for five years."

A person who commits one of the acts forbidden by sections 1000 or 1262(1) of the Corporations Law would clearly satisfy the elements of "deception" and "dishonesty" in section 178BA of the Crimes Act as the acts enumerated in subsections 1000(1) or

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[89] See paragraph 6.3.4.2 above and, in particular, the discussion on the dicta of the court in *Hornsby Building Information Centre Pty Ltd & Anor* v *Sydney Building Information Centre Ltd.*

[90] Section 178BB provides:

> "Whosoever, with intent to obtain for himself or another person any money or valuable thing or any financial advantage of any kind whatsoever, makes or publishes or concurs in making or publishing any statement (whether or not in writing) which he knows to be false or misleading in a material particular and is made with reckless disregard as to whether it is true or is false or misleading in a material particular shall be liable to imprisonment for five years."

[91] Section 185A provides that:

> "Whosoever, by any statement, promise, forecast which he knows to be misleading, false or deceptive, or by any dishonest concealment of material facts, or by reckless making (dishonestly or otherwise) of any statement, promise or forecast which is misleading, false or deceptive, induces or attempts to induce another person to take part or offer to take part in any arrangement with respect to property other than marketable securities, being arrangements the purpose or effect or pretended purpose or effect, of which is to enable persons taking part in arrangements (whether by becoming owners of the property or any part of the property or otherwise) to participate in or receive profits or income alleged to arise or to be likely to arise from the acquisition, holding, management or disposal of such property, or sums to be paid or alleged to be likely to be paid out of such profits or income, shall be liable to penal servitude for five years."

1262(1) require mens rea, that is, the offender either dishonestly conceals material facts or it is reckless in making or publishing false or misleading information or that it knows that the information which it disseminates is false or misleading. The third element, namely "obtains for himself or another person any money or valuable thing or any financial advantage" is also likely to be met as the objective in manipulative practices is to make money.

These three elements being likely to be present, it is suggested that subsection 178BA(1) has the potential to prohibit those malpractices proscribed by sections 1000 and 1262 of the Corporations Law.

Analysis of section 178BB of the Crimes Act

The elements of this offence are firstly, an intention to obtain money or financial advantage; secondly, the act of making or publishing an oral or written statement; and thirdly that statement is false or misleading in a material particular. This offence provision is broadly similar to sections 1000 and 1262 of the Corporations Law. The requirement in section 178BB of the Crimes Act that there must be an intention to obtain a pecuniary advantage or a valuable thing is easily satisfied as manoeuvres such as runs are organised so that the organisers can make money. The second element, which is the making or publishing of a statement, is also a requirement of sections 1000 and 1262 of the Corporations Law. The third element, which is that the statement is false is likewise a requirement of the Corporations Law. Section 178BB is thus a possible stand in for sections 1000 and 1262 of the Corporations Law.

Analysis of section 185A of the Crimes Act

As explained in paragraph 6.3.3.2, section 185A of the Crimes Act does not apply to the sanctions regime in Chapter 7 of the Corporations Law in view of the exclusion of "marketable securities" from section 185A. This effectively rules out section 185A from being a substitute for section 1000 of the Corporations Law which applies only to contracts which are securities.

In relation to section 1262 of the Corporations Law, section 185A of the Crimes Act mirrors section 1262 in that the elements of the offences in both enactments are largely similar. Like section 185A, section 1262 requires:

1. the making of any statement, promise, forecast; and knowledge that such statement is misleading, false or deceptive; or
2. dishonest concealment of material facts; or
3. reckless making (dishonestly or otherwise) of any statement, promise or forecast which is misleading, false or deceptive; and

4. inducing or attempting to induce another person to deal in a futures contract.

Section 1262 is of wider scope and prohibits the recording or storing of information that the offender knows is false or misleading. Notwithstanding this difference, it is submitted that, in the absence of section 1262 of the Corporations Law, investors could rely on section 185A to provide adequate protection from offences covered under section 1262.

6.3.5 *Dissemination of information about illegal transactions (sections 1001, 1263)*

In the preceding paragraph it was noted that the dissemination of information about a target stock or futures contract could help to build up a demand for that stock or futures contract. If the dissemination of information on the manipulator's illegal market practices is controlled or forbidden, it would stamp out a good portion of illicit market activity. Both Chapters 7 and 8 contains provisions discouraging dissemination of information about illegal transactions. Section 1001 in Chapter 7 prohibits the circulation or dissemination of information to the effect that the price of any securities is likely to rise, fall or be maintained because of any activities contravening sections 997 (stock market manipulation), 998 (false trading and market rigging), 999 (false or misleading statements) and 1000 (fraudulently inducing persons to deal in securities). Section 1263 mirrors section 1001 but in relation to futures contracts. It outlaws the circulation or dissemination of information that the price for dealings in futures contracts is likely to rise, fall or maintained because of activities contravening sections 1259 (futures market manipulation), 1260 (false trading and market rigging), 1261 (false or misleading statements) or 1262 (fraudulently inducing persons to deal in futures contracts). Sections 1001 and 1263 are directed at those operators of stock market newsletters or tipster sheets or like publication who are acting in concert with the manipulators.[92] They would also catch manipulators or associates of such manipulators from circulating information about the predicted movement of the price of securities or futures contracts by virtue of illegal market rigging activities.[93]

6.3.5.1 Applicability of TPA

Sections 1001 and 1263 strike at predicting movements of the price of securities or futures contracts by circulating information about illegal market rigging activities. The circulating of information about an illegal activity which is taking place or about to

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[92] Meyer, PW, note 88, 92 at 101. The discussion was on section 127 of the Securities Industry Code which, as it was the forerunner of section 1001 of the Corporations Law, would be just as relevant to sections 1001 and 1263 of the Corporations Law.

[93] Meyer, PW, note 88, 101.

take place is not misleading per se, if such an activity is or will be a reality. In relation to the dissemination of information of future illegal activities, section 51A(1) TPA[94] deems a representation as to a future matter to be misleading if the manipulator does not have reasonable grounds for making that representation. If it has, the conduct proscribed under sections 1001 and 1263 will not give rise to a cause of action under section 52 TPA or its equivalent under State consumer legislation.

Given that speculators (or investors) are not gullible, it is expected that in most cases, the manipulators would be compelled to enter the market to provide evidence of unusual market activity in an attempt to convince the speculators or investors to trade in the market and thereby to provide them, the manipulators, with the opportunity to reap rich profits. Speculators will trade if they are of the view that the illegal market activities would fuel price increases further, enabling them also to profit. In this scenario, the manipulator would have reasonable grounds for making that representation because the illegal activities are taking place or about to take place. Whether in fact any manipulator would ever be so imprudent as to provide proof of reasonable grounds (and thereby subject itself to the prospect of prosecution under section 1001 or 1263) is not the issue. What is important here is that section 52 TPA would not be available against the manipulator if the illegal market activities actually take place.

However, if the dissemination of information is on illegal activities which are not intended to be carried out, then such conduct would be misleading conduct under section 52 TPA and would be in contravention of this provision. In practice, the illegal activities are likely to be carried out and if that be the case, there is no misleading conduct and section 52 TPA would not be available for filling in the gap in investor protection in the Corporations Law regime.

6.3.5.2 Applicability of the Crimes Act

Section 178BB[95] (obtaining money, etc. by false or misleading statement) and section 185A[96] (inducing persons to enter into certain arrangements by misleading, etc.

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[94] Parallel provisions in the States legislation are section 41 of *Consumer Affairs and Fair Trading Act 1990* (NT); section 9 of the *Fair Trading Act 1987* (WA); section 37 of *the Fair Trading Act 1989* (Qld); section 11 of thc *Fair Trading Act 1990* (Tas); section 11 of the *Fair Trading Act 1992* (ACT); section 10A of the *Fair Trading Act 1985* (Vic); section 41 of the *Fair Trading Act 1987* (NSW); section 54 of the *Fair Trading Act 1987* (SA).

[95] Section 178BB provides:

> "Whosoever, with intent to obtain for himself or another person any money or valuable thing or any financial advantage of any kind whatsoever, makes or publishes or concurs in making or publishing any statement (whether or not in writing) which he knows to be false or misleading in a material particular and is made with reckless disregard as to whether it is true or is false or misleading in a material particular shall be liable to imprisonment for five

statements) could conceivably be relevant as both sections involve the dissemination of false statements. Subsection 178BA(1), although it does not concern the dissemination of statements, is of great width and is also examined to determine its capacity to be used as a substitute for sections 1001 and 1263 of the Corporations Law.

Analysis of subsection 178BA(1)

The main elements of the offence in subsection 178BA(1) are deception and obtaining for itself or another person money or a valuable thing or financial advantage. A significant difference between section 178BA of the Crimes Act and sections 1001 and 1263 of the Corporations Law is that for there to be an offence under the Crimes Act, mens rea (in the form of dishonesty, or knowledge that the statement is false or misleading or that the statement is made recklessly) must be present. Sections 1001 and 1263 of the Corporations Law, on the other hand, like many of the other provisions in the same enactment, are in the nature of "strict liability" offences. There is no requirement in those sections that the offender must possess a "guilty mind". ."Deception", as defined in subsection 178BA(2), is deliberate or reckless deception by words or conduct as to fact or as to law. This element in section 178BA(1) is not satisfied. It is to be concluded that section 178BA of the Crimes Act is unhelpful as a substitute for the offences provisions in sections 1001 and 1263 of the Corporations Law.

Analysis of section 178BB of the Crimes Act

The first requirement of this offence, an intention to obtain money or financial advantage; is met as all manipulative exercises in the futures or securities markets are carried out with the intention of gaining profits. The offences covered under section 1001 or 1263 of the Corporations Law are no exceptions. The second element of this offence, the act of making or publishing an oral or written statement; is also met as an ingredient of sections 1001 and 1263 is the circulation of information about illegal

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years."

[96] Section 185A provides that:

"Whosoever, by any statement, promise, forecast which he knows to be misleading, false or deceptive, or by any dishonest concealment of material facts, or by reckless making (dishonestly or otherwise) of any statement, promise or forecast which is misleading, false or deceptive, induces or attempts to induce another person to take part or offer to take part in any arrangement with respect to property other than marketable securities, being arrangements the purpose or effect or pretended purpose or effect, of which is to enable persons taking part in arrangements (whether by becoming owners of the property or any part of the property or otherwise) to participate in or receive profits or income alleged to arise or to be likely to arise from the acquisition, holding, management or disposal of such property, or sums to be paid or alleged to be likely to be paid out of such profits or income, shall be liable to penal servitude for five years."

market rigging activities. The final requirement, that statement is false or misleading in a material particular, may or may not be met depending on the circumstances. This has been explained in paragraph 6.3.5.2 in relation to the discussion on the TPA. It is likely that this third requirement will not be met as the statements made would likely to be true. In practice, section 178BB is unlikely to be a substitute for sections 1001 and 1263 of the Corporations Law.

Analysis of section 185A of the Crimes Act

It has been established above that section 185A of the Crimes Act does not apply to the sanctions regime in Chapter 7 of the Corporations Law in view of the exclusion of "marketable securities" from section 185A. This effectively rules out section 185A from being a substitute for section 1001 of the Corporations Law which applies only to contracts which are securities.

One of the key criteria of the offence in section 185A of the Crimes Act is knowledge that the information or statement disseminated is misleading, false or deceptive or is a dishonest concealment of material facts or constitutes reckless making (dishonestly or otherwise) of any statement, promise or forecast which is misleading, false or deceptive. As noted in the analysis on section 178BB of the Crimes Act in relation to section 1263 of the Corporations Law, this latter section is in the nature of "strict liability" offence. There is no requirement in section 1263 that the offender must possess the "guilty mind" Section 185A of the Crimes Act is not a substitute for section 1263 of the Corporations Law.

6.3.5.3 Gap in the Crimes Act and TPA

The analysis in this paragraph 6.3.5 reveals that a regulatory gap exist in the general law as neither the Crimes Act nor the TPA has provisions equivalent to sections 1001 and 1263 of the Corporations Law.

6.4 Fraudulent conduct

Outright fraud and misappropriation are not dealt with under the Corporations Law but under the criminal legislation of the States. The offences discussed in this paragraph 6.4 are therefore not conduct which are blatantly criminal but an undesirable market practice which could be considered as a "fraud" on investors. In the context of the securities and futures market, two groups of fraudulent conduct may be distinguished - those which occur in the OTC markets[97] and those which occur in the on-exchange markets. This latter group generally involves legitimate transactions but

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[97] See Gunningham, N, note 12, 821. Chaikin, 'Commodity Investment Fraud', 1985, 6 *Company Lawyer*, 261 describes this as fraud masquerading as legitimate commodity investments.

which are tainted by an element of fraud.[98] As this thesis is concerned with the OTC markets, only fraudulent conduct in the OTC markets are being examined.

Common forms of OTC malpractices which are not generally recognised by criminal legislation as a fraud but considered as a "fraud" on investors include bucketing and those transactions involving leverage currency (prohibited under section 1258 of the Corporations Law) as well as frontrunning (prohibited by sections 844 and 1266). These offences have been discussed in paragraph 6.2 above. One other section of the Corporations Law which deals with offences within this category is section 1264.

6.4.1 Fraud in connection with dealings in futures contracts (section 1264)

Section 1264[99] of the Corporations Law is directed at brokers and prohibits conduct which defrauds the client of a broker. The section is widely drafted and has the capacity to catch all manner of abuses inflicted by the broker on its client. Any of the following acts by a broker will be an offence under this section:

(a) defrauding (ie cheating) a client; or

(b) making a statement or entry in a record with knowledge that (or recklessly indifferent as to whether) the client will be deceived or mislead; or

(b) doing an act or omitting to do an act with knowledge that (or recklessly indifferent as to whether) the client will be deceived or mislead.

It has been suggested that this section also covers frontrunning as "the action of taking advantage of a market situation or price available in some way to favour the broker's house orders over client orders may amount to fraud on the client under section 1264(c) or misleading and deceiving the client under section 1264(d)."[100] The section also covers "churning"[101] which has been held in the United States in *Mihara v Dean*

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[98] Gunningham, N, note 12, 821.

[99] Section 1264 provides that a person contravenes the section:

> Where, in connection with a dealing or proposed dealing in a futures contract by a futures broker on behalf of a client of the broker, a person who:
> (a) is the broker or an employee or agent of the broker; or
> (b) has an interest, or is otherwise concerned in, the dealing or proposed dealing;
> does any of the following:
> (c) defrauds the client;
> (d) does an act, or omits to do an act, knowing that the client will be deceived or misled, or with reckless indifference as to whether or not the client will be deceived or misled...;
> (e) ...makes a statement, promise, forecast to the client...
> (i) knowing that the statement...is false, misleading or deceptive...; or
> (ii) with reckless indifference as to whether the statement...is false, misleading or deceptive.."

[100] Currie, JS, note 11, 237.

[101] Hains, MG, note 2, 81,309.

Whitter[102] to be possibly a fraud within the Rule 10b-5 of the Securities Exchange Act 1934.[103]

6.4.1.2 Applicability of TPA

The offence in section 1264 is constituted by a broker or its agent defrauding, misleading or deceiving its clients either deliberately or recklessly. It is clear from a reading of section 1264 that the circumstances which would be a contravention of that provision would likely also be an infringement of section 52 TPA, given the similarity of the conduct impugned by both provisions, except where fraud is the subject matter of the complaint in section 1264. Whether fraudulent conduct in section 1264 is misleading or deceptive within the meaning of section 52 TPA will depend on the facts of a particular case. Frontrunning,[104] a practice which sections 844 and 1266[105] seek to prohibit, may amount to fraud,[106] but that conduct is not necessarily misleading or deceptive. This is because the client did not in fact form an erroneous conclusion by reason of any misleading or deceptive act of the broker when he or she first placed orders with the broker's house. In other words, the causation which is crucial to a case under section 52, is missing.[107] One may therefore conclude that section 52 TPA is not an alternative to section 1264 of the Corporations Law.

6.4.1.3 Analysis of the Crimes Act

The offences which section 1264 of the Corporations Law is intended to outlaw are conceivably also forbidden under sections 178BA, 178BB and 185A of the Crimes Act.

Analysis of subsection 178BA(1) - Obtaining money by deception

The requirements for deception and dishonesty in this subsection are satisfied by similar requirements in paragraph 1264(c)(d) and (e) of the Corporations Law. Although the requirement of obtaining any money or valuable thing or any financial advantage is not a requirement of section 1264, it is submitted that as the purpose of the deception is carried out for monetary gain, this element is likely to be present.

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[102] 619 F 2d, 814 (9th Cir 1980) cited in Wood, PR, note 34, 349.

[103] The material part of this rule provides that a person shall not, directly or indirectly, by the use of any means or instrumentality of inter-State commerce or of the mails or of any national securities exchange to employ any device or scheme to defraud, make untrue statement of a material fact or engage in any act or practice which would operate as a fraud or deceit upon any person in connection with the sale or purchase of securities.

[104] Frontrunning involves a broker taking advantage of a market situation to favour the broker's house orders over client orders.

[105] This has been discussed in paragraph 6.2.2 above.

[106] Currie, JS, note 11, 237

[107] *See Taco Company of Australia Inc. & Anor* v *Taco Bell Pty Ltd & Ors* (1982) ATPR, 40-303 at 43,750 per Deane and Fitzerald JJ.

Subsection 178BA of the Crimes Act is a possible alternative to section 1264 of the Corporations Law.

Analysis of section 178BB - obtaining money etc by false or misleading statement

The requirement in section 178BB of the Crimes Act that the offender must have the intention of obtaining for himself or another person any money or valuable thing or any financial advantage, as discussed in the preceding paragraph under the caption "Analysis of subsection 178BA(1) - Obtaining money by deception" is presumed to be present. The second element constituting the offence in section 178BB, the making or publishing or concurring in making or publishing any statement which the offender knows to be false or misleading in a material particular, mirrors paragraph 1264(e) of the Corporations Law. Section 178BB could be used as an alternative to section 1264 of the Corporations Law.

Analysis of section 185A - inducing persons to enter into certain arrangements by misleading etc statements

Section 185A of the Crimes Act forbids (a) the making or the reckless making of a false, misleading or deceptive statement, promise, forecast which (b) induces or attempts to induce others to participate in any arrangement with respect to property other than marketable securities or receive profits which arise or to be likely to arise from the acquisition, holding, management or disposal of such property. It is submitted that this provision has the capacity to prohibit most of the malpractices targeted by paragraph 1264(e) of the Corporations Law. The first element of section 185A of the Crimes Act, identified under (a) above is also to be found in paragraph 1264(e) of the Corporations Law which requires the making of a statement, promise, forecast which is false, misleading or deceptive. The second element, inducing or attempting to induce others to participate in any arrangement with respect to property is satisfied by the requirement in paragraph 1264(e) that the false or misleading statement be made in connection with a dealing or a proposed dealing.

6.5 Conclusion

The above review of alternative forms of protection for investors discloses that regulatory gaps exist in a substantial number of offence provisions targeted by the Corporations Law. It has been established that in approximately half of the securities and futures offences examined in this Chapter, no parallel provisions exist under the Crimes Act or the TPA. Examples of those offences in respect of which alternatives are not available under the Crimes Act or the TPA include sections 1078, 1002G, 1013, 1253, 1254, 1258, and 1266.

Even where protection is deemed to exist under these Acts, it is often less effective than those afforded under the Corporations Law. Some of the offence provisions in the Corporations Law, for example sections 1001 and 1263, are strict liability offences, which do not require proof of culpability. In relation to these, mere proof of the actus reus suffices to bring about a conviction under the Corporations Law. On the other hand, in the Crimes Act provisions examined in this Chapter (namely, sections 178BA, 178BB and 185A), mens rea is an ingredient of those offences. The requirement that culpability be established makes it more difficult to secure a conviction under the Crimes Act and, it may be concluded, renders the Crimes Act sanctions less effective.

Another conclusion which may be drawn from the study in this Chapter is that the sanctions provisions in the Crimes Act and the TPA, in some cases where they may conceivably apply, are not as wide as the equivalent Corporations Law provisions as regards the scope of their operation. For example, subsection 45(2) TPA would appear to have the potential to prohibit most of the offences forbidden by sections 997 and 1259 of the Corporations Law if the offences are committed by two or more persons. It is not, however, as broad in its scope of operation as sections 997 and 1259 of the Corporations Law in that it does not apply in situations where the offence is committed by a single person. The difficulty caused by the general laws to provide an exact fit for the offences in the futures and securities industries is again evident in the discussion on section 46 TPA in its application to the offences targeted by sections 997 and 1259. It was concluded that section 46 may be equated with sections 997 and 1259 of the Corporations Law in its ability to combat a "squeeze" on the basis that the term "competitor" as defined in subsection 46(1A) TPA would arguably include any shortseller. This position is not entirely free from doubt and would depend ultimately on the interpretation adopted by the courts. The crux of the problem seems to be that the general laws are not specifically intended for derivatives markets and in consequence are not co-extensive in the scope of their operation.

As the discussion above showed, the sanctions provisions of the Corporations Law themselves are riddled with gaps. Several examples may be cited. In paragraph 6.2.2, mention was made of the fact that section 1266 applies only to futures contracts and is not applicable to the broad range of OTC derivatives contracts (including securities) which are not futures contracts. In other words, section 1266 is of limited application. A second example is the insider trading provisions. It may be recalled from the discussion in paragraph 6.2.3 that these provisions are thought to be inadequate in that they do not cover all derivatives contracts. Sections 1002G, 1013, 1253 and 1254 do not apply to OTC derivatives contracts which are not regulated by Chapters 7 or 8 of

the Corporations Law. Although potentially applicable to all derivatives contracts, subsection 232(5), which is located outside of Chapters 7 and 8, provides limited protection to investors as it applies only to officers or employees of a corporation and not to all participants in the market. Yet another example is hawking which is proscribed by section 1078. This section is limited only to securities and there is no equivalent provision which forbids the hawking of futures contracts in Chapter 8 of the Corporations Law or indeed any other form of OTC derivatives contracts. This constitutes a regulatory gap in the Corporations Law.

The comparative analysis in this Chapter has identified some further gaps in the sanctions regime of the Corporations Law pertaining to futures and securities. The next Chapter examines the capacity of prudential regulators such as the Reserve Bank of Australia, the Insurance and Superannuation Commissioner and the Australian Financial Institutions Commission to provide adequate protection to investors trading in the OTC markets. The main objective is to identify gaps in the supervisory framework so that by this process, it would be possible to map out weaknesses in the regulatory structure governing the OTC markets.

CHAPTER 7

GAPS IN THE SUPERVISORY FRAMEWORK

7.1 Introduction

In Chapter 5 of this thesis, an analysis was carried out on the regimes in Chapters 7 and 8 of the Corporations Law and a number of regulatory gaps were identif ed in relation to the OTC derivatives market. As the main source of legislative control over financial derivatives are embodied in these two Chapters of the Corporations Law, the gaps constitute a major deficiency in the framework's capacity to protect investors. Chapter 6 of this thesis examined the consumer and criminal laws in Australia, to determine if these laws are capable of filling the vacuum in investor protection identified in the Corporations Law regime. The analysis, which was done on a comparative basis and focussed on the sanctions regimes in the *Trade Practices Act 1974* (Cth) (TPA) and the *Crimes Act 1900* (NSW) (Crimes Act), indicated that whilst these Acts have the potential to act as a substitute for some of the sanctions provisions in the Corporation Law, the ambit of their reach is not co-extensive. Some of the regulatory gaps remain.

Continuing with the evaluation of the regulatory framework for the OTC derivatives markets, and in recognition of the existence of a larger regulatory scheme for investor protection, this Chapter looks at the wider regulatory arrangements involving regulators and, in particular, prudential regulators and the prudential standards set by them in protecting investors. One of the primary aims of this Chapter is to determine if the current system of prudential regulation has the capacity to fill the remaining gaps in the Corporations Law. As part of this process, the present Chapter identifies the weaknesses in the supervisory arrangements as regards investor protection.

7.1.1 Overview of supervisory structure

The OTC derivatives market is subject to supervision by a number of regulatory agencies, most but not all of whom impose prudential standards on those they regulate. In the previous Chapter, a detailed analysis was made of some of the remedies available under the Corporations Law and the TPA to protect investors in the OTC derivatives market by targeting unlawful or misleading conduct. Compliance with the requirements of the Corporations Law is administered by the Australian Securities Commission (ASC) while the provisions in the TPA are enforced by the Australian Competition and Consumer Commission (ACCC).

Neither the ASC nor the ACCC is a prudential regulator. However, the ASC does have a limited prudential role but only with respect to securities and futures dealers and managers of collective investments.[1] It is primarily a product regulator in the sense that it is vested with jurisdiction in those transactions which involve a securities or a futures contract. Similarly, the ACCC may be regarded as an economy-wide enforcement agency, one of whose key functions is to encourage compliance with the TPA in respect of business conduct laws over which it has oversight responsibilities.[2] Although not prudential regulators per se, the ASC and ACCC nevertheless play or have the potential to play a key role in investor protection in the OTC derivatives market. As seen in the previous Chapter, the ASC is empowered to enforce those conduct provisions in the Corporations Law regime against offenders whilst the ACCC as the national consumer regulator, has available to it a range of remedies to be used against those who breached the consumer protection regime in the TPA. For that reason, the respective functions of these agencies are discussed alongside those of prudential regulators.

In Chapter 4, it was noted that prudential regulation is administered by national and state regulators and is industry or institution based. In other words, a national regulator such as the Reserve Bank of Australia (RBA) would have jurisdiction to supervise all banks within the banking industry. Similarly, insurance companies or superannuation funds are subjected to prudential regulation by the Insurance and Superannuation Commission (ISC) and at the State level, State Supervisory Authorities in conjunction with the Australian Financial Institutions Commission (AFIC) regulate building societies, friendly societies, credit unions and other State-based financial institutions.

A diagramatic representation of these regulators and the institutions or functions under their jurisdiction is in Figure 5 below.

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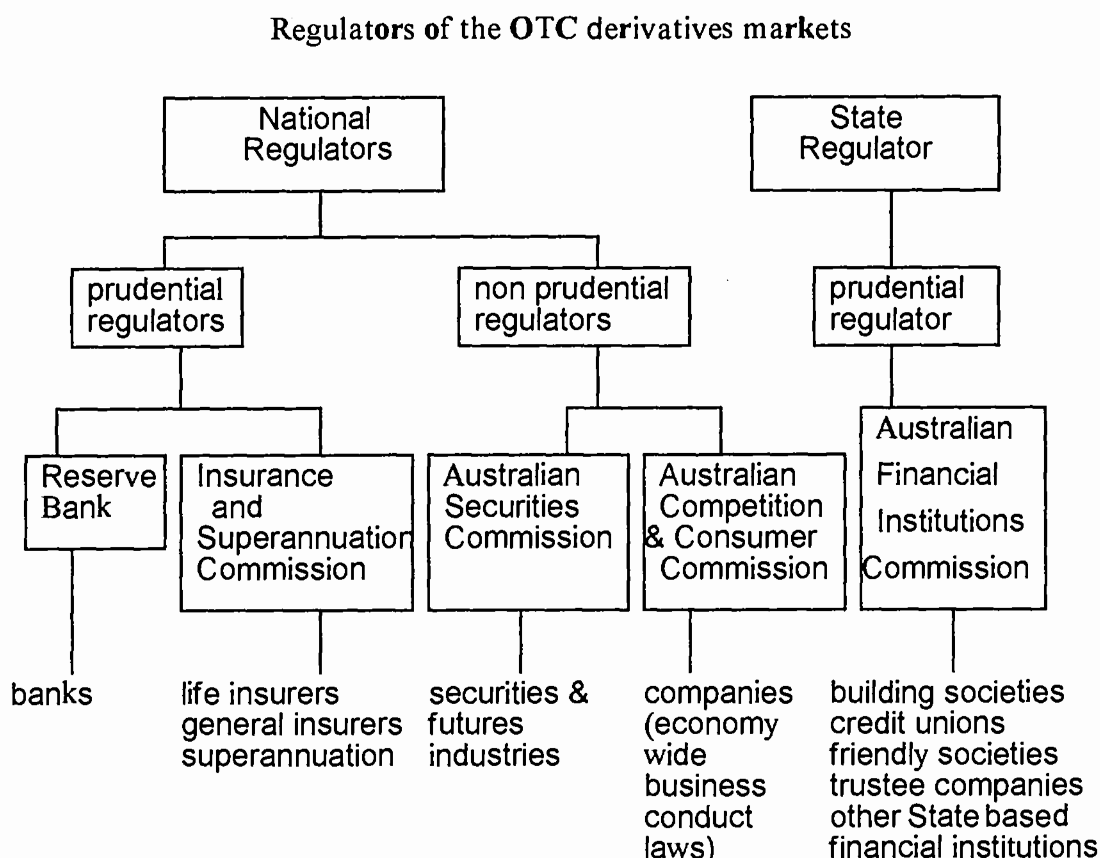
[1] Financial System Inquiry, *Discussion Paper*, Australian Government Publishing Service, November 1996 (Wallis DP), 188.

[2] Financial System Inquiry, *Financial System Inquiry Final Report*, Australian Government Publishing Service, March 1997 (Wallis Final Report), 239.

Figure 5

Regulators of the OTC derivatives markets



7.2 The Regulators for OTC markets

This section provides a brief description of the role and responsibilities of the regulatory agencies with jurisdiction in the OTC derivatives markets.

7.2.1 *The Reserve Bank of Australia*

The RBA has a number of functions, but it is with its function as a regulator for banks that this Chapter is concerned. The RBA has three main objectives, which are:[3]

(a) maintaining the confidence in the banking system as a whole;

(b) ensuring the stability and integrity of the banking system through prudential regulation and in the event of a bank failure it is adequately empowered under section 14 of the *Banking Act 1959* (Cth) to assume control of the bank; and

[3] Wallis DP, note 1, 280, 360.

(c) ensuring depositor protection which it is empowered to do under section 12 of the *Banking Act 1959* (Cth) wherein it is provided that the RBA is required to exercise its powers and functions for the protection of bank depositors. Under section 16 of the *Banking Act 1959* (Cth), depositors are given priority over other liabilities of a bank if it fails.[4]

The primary legislation relevant to the RBA includes the *Reserve Bank Act 1959* (Cth) and the *Banking Act 1959* (Cth) and the Regulations made thereunder.

Regulation of banks is by way of prudential controls, aimed at enhancing investor protection.[5] These controls include:

(a) capital adequacy requirements;

(b) liquidity requirements, including meeting the Bank's Prime Assets Requirement Ratio;

(c) liquidity management systems requirement;

(d) restrictions on banks' association with non-banks; and

(e) limitations on the amount of credit exposure to a single borrower.[6]

In the context of derivatives, capital adequacy requirements are the most important. These rules are intended to ensure that a bank has sufficient funds to remain solvent and to continue to operate after sustaining losses. Australian banks are required by the RBA, under Prudential Statement No C1,[7] to meet the Bank for International Settlements (BIS) standard for measuring primary capital and for relating minimum capital requirements to the risk profiles of banks.[8] Basically a bank must maintain a minimum ratio of capital[9] to risk adjusted assets[10] of 1:12.5 with tier 1 capital[11] making up at least half the capital of each bank.[12] Off-balance sheet items, which include derivatives,[13] are required to be brought into the equation by using credit

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[4] Wallis DP, note 1, 281.

[5] Australian Securities Commission, 'Report On Over-The-Counter Derivatives Markets', 1994 (ASC Final Report), Appendix 5, paragraph 6.

[6] ASC Final Report, note5, Appendix 5, paragraph 6; Wallis DP, note 1, 362.

[7] ASC Final Report, note 5, Appendix 5, paragraph 8, f/n 7.

[8] ASC Final Report, note 5, Appendix 5, paragraph 7.

[9] The capital here comprise both tier 1 capital (share capital, retained earnings and general reserves) and tier 2 capital (asset revaluation reserves, subordinated debts, etc): see ASC Final Report, note 5, Appendix 5, paragraph 7, f/n 4.

[10] Assets on the balance sheet are weighted according to broad categories of risk based on the nature of the counterparty, guarantor or the security held: see ASC Final Report, note 5, Appendix 5, paragraph 9, also f/n 8.

[11] Tier 1 capital is made up of ordinary shares, non cumulative preference shares, retained earnings, general reserves, etc: ASC Final Report, note 5, Appendix 5, paragraph 7, f/n 4.

[12] Tier 1 capital must be at least 4% of the bank's risk adjusted asset.

[13] ASC Final Report, note 5, Appendix 5, paragraph 10.

conversion factors based on the BIS report entitled 'International Convergence of Capital Measurement and Capital Standards' and then risk weighting the resulting credit equivalent amounts.[14] It was pointed out in Chapter 3 that the practice of classifying derivatives as off-balance sheet items was an issue of some concern. The implementation of Prudential Statement No CI has put to rest this concern, at least in relation to banks.

The RBA has an important role in the capital markets as it has the largest portion of managed funds in the market under its jurisdiction, representing about 51 percent of the total funds under management in Australia.[15] By supervising the banks, the RBA ensures that the credit risk to investors such as bank depositors and shareholders are minimised. Whilst prudential regulation (which is aimed at keeping banks solvent) would help to reduce the credit risks of counterparties in OTC derivatives contracts, it could not be used as an option for the regime in Chapters 7 and 8 of the Corporations Law. This is because prudential regulation applies only to one party to the transaction, namely the bank and not to both parties, as in the case of derivatives contracts governed by the Corporations Law. Prudential regulation has no application to counterparties to OTC derivatives contracts unless the counterparties are regulated entities.

7.2.2 *The Insurance and Superannuation Commission*

The Insurance and Superannuation Commission (ISC) is established in 1987 as a statutory authority pursuant to subsection 4(1) of the *Insurance Superannuation Commissioner Act 1987* (Cth). The ISC's primary function is to supervise both life and general insurance industries. It also has responsibility for superannuation funds.

The principal legislation concerning the ISC includes:

(a) The *Life Insurance Act 1995*;

(b) The *Insurance Act 1973*;

(c) The *Insurance (Agents and Brokers) Act 1984*;

(d) The *Insurance Superannuation Commissioner Act 1987;* and

(e) The *Superannuation Industry (Supervision) Act 1993*.

The ISC's major policy objective for the use of derivatives is to ensure that its regulatees have in place adequate controls and adequate internal and external checks on compliance with those controls.[16] Currently, superannuation funds use derivatives

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[14] ASC Final Report, note 5, Appendix 5, paragraph 9.

[15] Wallis DP, note 1, 359, Figure C.1.

[16] Insurance and Superannuation Commission, Media Release, 'Discussion papers on Derivatives',

for hedging, short-term balancing of asset allocation and for reducing transaction costs and, in the case of some funds, also as a profit centre for the purpose of generating income through financial leverage.[17]

On 2 April 1996, the ISC released its guidelines on "Fund Reference RMS" which provide a framework for derivatives investment and linking it to a fund's investment strategy.[18] Essentially, trustees of superannuation fund are required to prepare Risk Management Statements (RMS)[19] comprising of two parts. Part A is referred to as "Fund Reference RMS" and is designed to ensure that a trustee understands what its investment strategy calls for and how that is connected to the derivatives investment actually made in respect of the fund.[20] It sets the framework for derivatives investment and links it to a fund's investment strategy.

Part B which is referred to as "Detailed RMS" requires details of derivatives usage and the controls used by a party responsible for implementing derivatives investment decisions. It must state the purpose for which derivatives have been employed and show how this purpose is tied in with the investment strategy of a particular fund.[21] The RMS need not be lodged by all funds. Funds which do not use derivatives and funds which have fewer than five members are exempted from preparing an RMS.[22] The majority of the approximately 140,000 regulated superannuation funds are small with fewer than five members. Most regulated superannuation funds are therefore exempted from lodging an RMS.[23]

It is submitted that prudential regulation by the ISC through the imposition of an RMS does not provide equivalent conduct regulation similar to those in the Corporations Law. There are no specific provisions in insurance and superannuation legislation restricting the use of derivatives products. However, the requirement of an RMS may discourage the use of derivatives. In addition, two other factors may curtail usage. First, potential exposures on derivatives are to be reported to the ISC which in turn uses the information to determine capital adequacy requirements.[24]

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27 March 1995, 1.

[17] Jay, C, 'Super Sector Steps Up Controls on Derivatives', *The Australian Financial Review*, 14 May 1996, 37.

[18] Blake Dawson Waldron, 'Superannuation', in *Canberra Notes*, May 1996, 13.

[19] RMS is discussed in detail in Naughton, G, 'The Use of Derivatives in Superannuation Funds', a paper presented at Superannuation 1996: A National Conference for Lawyers, Sydney, 1996.

[20] Haines, P, 'Risk Management Requirements On Trustees", *The Australian Financial Review*, 7 May 1996, 42

[21] Haines, P, note 20, 42.

[22] Haines, P, note 20, 42.

[23] Wallis DP, note 1, 193.

[24] ASC Final Report, note 5, Appendix 5, paragraph 31.

Second, the financial position of life companies are required to be assessed by an appointed actuary who would take into consideration potential exposures under derivatives contracts.[25]

The market share of funds under the jurisdiction of the ISC is approximately 30 percent of the total funds under management in Australia.[26] However, it is projected that at the current growth rates the size of the industry will double every eight years and will reach over 1,000 billion by the year 2015.[27] Given that the majority of all Australians look to superannuation funds to provide for their retirement, pubic interest would demand that the regulation provide for financial safety of the funds.

7.2.3 *The Australian Financial Institution Commission*

The AFIC[28] was established by the financial institutions legislation as a national body to set standards for State supervisors of non banks such as building societies and credit unions. It reports to the Ministerial Council of Financial Institutions (MINFIN) which comprises of State Ministers who have responsibility for credit unions and building societies in their jurisdictions.[29] Its primary functions are firstly, to protect and promote financial integrity and efficiency of the State-based financial institutions system and secondly, to ensure depositors' protection and thirdly, to ensure uniform regulation of these institutions.[30]

The financial institutions legislation is a package of legislation and regulation enacted in Queensland and subsequently applied to the States and Territories. In the Australian Capital Territory, the *Australian Financial Institutions Commission Act 1992* (Queensland) is applied to the Australian Capital Territory by the *Financial Institutions (Application of Laws) Act 1992* (ACT).

The relevant legislation, in relation to non banks financial institutions in the Australian Capital Territory, includes:

(a) The *Australian Financial Institutions Commission Act 1992* (Queensland);

(b) The *Financial Institutions (Queensland) Act 1992* (Queensland);

(c) The *Financial Institutions (Application of Laws) Act 1992 (ACT);*

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[25] ASC Final Report, note 5, Appendix 5, paragraph 31.

[26] Wallis DP, note 1, 359, Figure C.1.

[27] Dunstan, B, 'Industry Has Two Ways to Go On Wallis Report', *Financial Review*, 17 April 1997, 23.

[28] The Commission was established by the *Australian Financial Institutions Commission Act 1992* (Queensland).

[29] Wallis DP, note 1, 363.

[30] ASC Final Report, note 5, Appendix 5, paragraph 22; also Wallis DP, note 1, 363, 364.

(d) The *Financial Institutions (Supervisory Authority) Act 1992 (ACT)* and regulations made thereunder;
(e) The *Financial Institutions (ACT) Code;* and
(f) The Financial Institutions (ACT) Regulation;

The regime imposes restrictions on the purposes for which derivatives may be entered into,[31] the type of derivative contracts to which these non banking institutions may participate and the types of counterparties to these derivative contracts (eg only banks).[32] The purpose test would preclude speculative activities by the regulatees. The regulation appears to be more intrusive than those for banks in relation to derivatives, possibly because there are no special depositor protection for building societies or credit unions. The depositors of non bank financial institutions are not given any preference in a liquidation.[33]

Key prudential regulation includes risk management, operational liquidity, market and credit risks, capital adequacy, accounting and disclosure, managed fund products and industry-funded emergency liquidity support arrangements.[34] Enforcement is through State Supervisory Authority, which in the Australian Capital Territory is the Registrar of Financial Institutions.

The market share of funds under the jurisdiction of the AFIC is not large, representing about three per cent of the total funds under management in Australia.[35]

7.2.4 *The Australian Securities Commission*

The Australian Securities Commission (ASC) is established by section 7 of the *Australian Securities Commission Act 1989* (ASC Act). Its functions are spelt out in section 1(2) of the ASC Act and these include:

- maintaining the confidence of investors in the securities and futures markets by ensuring adequate protection for those investors; and
- maintaining, facilitating and improving the performance of companies and of the securities and futures markets in the interest of commercial certainty, reducing business costs and the efficiency and development of the economy.

The legislation which concerns the ASC includes:

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[31] For hedging purposes only: see Companies & Securities Advisory Committee, 'Regulation of the OTC Derivatives Market, Discussion Paper', 1995 (CASAC, DP), 14.
[32] CASAC, DP, note 31, 11-14.
[33] Wallis DP, note 1, 282.
[34] Wallis DP, note 1, 364-65.
[35] Wallis DP, note 1, 359, Figure C.1.

1. The Corporations Law and the Corporations Regulations;
2. *Australian Securities Commission Act 1989* and the ASC Regulations; and
3. *Corporations Act 1989*.

The ASC's role as a regulator in the OTC markets is less intrusive compared to its role in on-exchange markets. The regimes in Chapters 7 and 8 are intended mainly for the on-exchange market with the result that many of the provisions for investor protection applies only to the on-exchange markets. Three specific examples help to illustrate this point.

First, the licensing provisions in the Corporations Law is of limited application. They apply only to transactions undertaken by a dealer on behalf of another person and do not apply to an OTC derivatives seller, for example, a market maker, who contracts with the investors as a principal.[36]

Second, the Corporations Law imposes no specific risk disclosure obligations for the off-exchange markets whereas in the on-exchange markets, futures brokers are required under section 1210 to provide certain information to prospective clients.[37] In this connection, section 995 of the Corporations Law, which imposes civil liability for misleading or deceptive conduct, is of no assistance, as it applies to those limited categories which are "securities".[38]

A third example is that the protection afforded to investors by section 1141 (in relation to futures contracts) and section 778 (in relation to securities) is limited to contracts traded on-exchange and those traded in an exempt market. Therefore contracts traded on OTC markets which are not exempt markets would be void if they infringe the States gaming or wagering legislation.

Apart from the above, it has been seen in Chapter 5 of this thesis that a large group of OTC derivatives contracts fall outside the Corporations Law, principally because they are not deemed to be futures contracts by reason of the exclusion in paragraph 72(1)(d). It is conceded that the bank participant who is a party to these contracts would be subject to the prudential supervision of the RBA but the counterparties are not subject to prudential regulation (unless they are banks) nor are they subject to governed by the offence provisions in Part 8.7 of the Corporations Law (because Part 8.7 applies only to futures contracts and these are excluded from futures contracts) nor

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[36] ASC Final Report, note 5, paragraph 244.
[37] CASAC, DP, note 31, 28-9.
[38] CASAC, DP, note 31, 28, f/n 74.

are they subject to the offences provisions in relation to securities in Part 7.11 (unless they are within the definition of "securities"). As this group of excluded contracts comprise about 66 percent of the derivatives transaction in Australia, it may be fair to conclude that the ASC has jurisdiction over only a small portion of OTC contracts. Presently, the ASC supervises about 13 percent of the total funds under management in Australia.[39]

7.2.5 *The Australian Competition and Consumer Commission*

The Australian Competition and Consumer Commission (ACCC) is established in 1995 as a body corporate pursuant to subsection 6A(1) of the TPA. Its responsibilities include oversight of restrictive trade practices activities, consumer protection and price surveillance,[40] although this Chapter is concerned with its responsibility for investor protection.

The primary legislation governing the ACCC is:

1. The *Trade Practices Act 1974* (Cth); and
2. The *Prices Surveillance Act 1983* (Cth).

The ACCC is not a prudential regulator but has economy wide jurisdiction within the parameters set by the TPA. Its main focus is consumer protection. Such protection is given force of law by virtue of sections 45, 46, 50, 52 and 53 of the TPA. These provisions have been discussed in Appendix 1 of this thesis and in the previous Chapter. For this reason it suffices merely to note that the ACCC plays a key role in consumer protection.

The TPA has a legislative bias towards disclosure of information and imposes on the ACCC extensive responsibilities in relation to the disseminating information and law. Section 28 spells out six key areas in which the ACCC is to play a role in making information available. Therefore, in addition to the ACCC's other functions, its "information" functions include making available general information on the powers and functions of the ACCC, advising the Minister on consumers' protection matters which have been referred by the Minister to the ACCC, conducting research on matters relating to consumers interests, making available to the public general information on matters affecting the interest of consumers and making known to consumers the rights and obligations of persons under provision of laws in force in Australia that are designed to protect the interest of consumers.

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[39] Wallis DP, note 1, 359, Figure C.1.
[40] Wallis DP, note 1, 376.

7.3 Gaps arising from the supervisory structure

The brief examination of the regulatory agencies above reveals a fragmented approach to regulating investor protection. A criticism which may be levied against the supervisory structure is the unsatisfactory regulatory arrangement. Regulators are broadly divided into two groups: prudential and non prudential regulators. Such an arrangement lends itself to regulatory gaps, as there is no systematic coverage of the entire OTC derivatives market either by the prudential regulators or the non-prudential regulator or by the combined oversight responsibilities of both sets of regulators. The regulatory reach of non prudential regulators is economy wide but narrowly focused. For instance, the ASC is not vested with authority to oversee an OTC derivatives transaction unless that transaction falls within Chapter 7 or 8 of the Corporations Law and the ACCC has jurisdiction only if the conduct complained of infringes the TPA. Regulation through prudential regulators such as the RBA (which regulates only banks), the ISC (which regulates only insurance companies and trustees of superannuation funds) and AFIC (which regulates non bank financial institutions), is demarcated along institutional lines.

Gaps arise because the combined regulatory net of these agencies, prudential and non prudential, does not extend to all the participants in the OTC derivatives markets, but only those within the jurisdiction of each regulator. An example of a participant within the gap would be a counterparty to a derivatives contract in paragraph 72(1)(d) of the Corporations Law which, for the purpose of this illustration, is a trading corporation which has not contravened the TPA. Such a participant would not be subject to supervision by the ASC,[41] the RBA,[42] the ISC,[43] the AFIC[44] or the ACCC.[45]

Secondly, because prudential regulators do not have supervisory jurisdiction over participants who are counterparties, they are unable to ensure that they too observe prudential standards so that equity investors and other stakeholders in these counterparties would enjoy some measure of protection from risk of loss. It is submitted that control over all participants is important as the existing institutional approach to prudential regulation could encourage the emergence of new entities that could compete with banks, insurance companies, trustees of superannuation funds and State based financial institutions. These entities could exploit the gaps in the

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[41] This is because the transaction is within paragraph 72(1)(d) and as such is not a futures contract in respect of which the ASC can have jurisdiction.
[42] For this example, it has been assumed that the counterparty is not a bank.
[43] Likewise it is assumed that the counterparty is not an insurance company or a trustee of a superannuation fund.
[44] The counterparty is also not a State based financial institution.
[45] This is because the assumption for this example is that it is a transaction that has not contravened the TPA.

supervisory structure by selling products and services free from prudential or statutory requirements. Not only will the non regulated participants enjoy an advantage which the freedom from regulation offers,[46] (and thereby create competitive disadvantage for regulated entities in the OTC derivatives market), the absence of prudential regulation will also expose those who invest in them, whether as shareholders or otherwise, to the risks which prudential regulation is designed to minimise. In the interest of the public and, in particular, the investors of the OTC markets, there should be prudential regulation for the OTC market participants.

Prudential regulation concentrates on financial safety of the institutions regulated and is aimed at protecting markets and funds from credit and systemic risks.[47] As such, it does not deal with conduct regulation, nor is it expected to. Neither the RBA, ISC nor the AFIC provide regulation on insider trading, hawking or other undesirable market conduct. For this reason, it is to be concluded that prudential regulation is no substitute for filling the gaps in the Corporations Law regime.

Another disconcerting aspect of the regulatory system which is a direct consequence of fragmentation is the lack of uniformity in the strategies employed by each prudential regulator in relation to derivatives trading. At the bottom end of the scale is the ISC which requires only that a RMS be completed by those insurance companies and superannuation trustees under its supervision while at the other end is the AFIC which, because of the requirements of the Australian Financial Institutions legislation[48] adopts a fairly heavy handed approach. The RBA, which favours a holistic approach,[49] treads a middle path by concentrating on prudential controls such as capital adequacy requirements and credit exposure to a single borrower.

Recent trends in the financial sector have seen the blurring of services offered by institutions, with banks selling superannuation products and insurances and superannuation funds selling products traditionally offered by banks such as home loans.[50] Although it is recognised that some institutions have characteristics that warrant a higher level of regulation than others,[51] the different regulatory treatment

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[46] See Wallis DP, note 1, 203.

[47] International Organisation of Securities Commission, 'Regulation of Derivative Markets, Products and Financial Intermediaries: Collated Summary of Responses to Common Framework of Analysis and Cross Regulatory Summary Chart', October 1993, 9.

[48] See for example section 120 of the *Australian Financial Institutions Code*.

[49] The Reserve Bank's views are that the risks faced by banks using derivatives cannot be considered in isolation and that its approach "has been to address the types of risks, irrespective of the type of instrument which produces the risk." See Austin, LJ, 'Derivatives: The Reserve Bank of Australia Regulatory Perspective', a speech delivered at Sheraton on the Park Hotel, Sydney, 28 August 1995, 1.

[50] Mitchell, A, 'Dangers of a super-watchdog', *The Australian Financial Review*, 31 May 1996, 18.

[51] Wallis Final Report, note 2, 189.

applying to products with essentially the same characteristics means that investors would receive different standards of protection[52] depending on the party from whom the product was purchased. This could put heavily regulated industries at a competitive disadvantage and conversely, expose investors in less regulated industries to greater risk of loss.

The current regulatory arrangement also gives rise to other gaps and inconsistencies in investor protection in the area of sales and investment advice and point of sale disclosure. Advising on the sale or purchase of or selling securities or superannuation is controlled under a licensing regime in the Corporations Law[53] and advising on the sale of or selling life products is subject to a separate regime in the Life Code of Practice. There is no similar regime in place for sales and advice on bank products.[54] This constitute a "gap" in investor protection. Similarly, there is presently no consistency in approach in point of sale disclosure requirements. Product disclosure standards vary depending on whether the products are securities, bank products or insurance and superannuation products as each type of products is subject to its own separate disclosure requirements.[55]

7.4 Conclusion

This Chapter has established that gaps exist in the supervisory structure with the result that some parties trading in OTC derivatives are not subject to any supervision. As explained earlier in this Chapter, the gaps will have investor protection implications. The Chapter has also highlighted a number of deficiencies or inconsistencies in the approach adopted by individual regulators and the possible effects which such inconsistencies will have on investor protection. The regulatory arrangement, as it stands, is outdated and could benefit from improvement. In recent months, two major reports have been released which will have an impact on the regulatory structure for OTC derivatives. These will be discussed in the next Chapter.

Having completed the review of the regulatory structure concerning the OTC derivatives market in this and the previous two Chapters from the perspective of investor protection, the next Chapter will also draw together the findings of this thesis and discuss their implications. Recommendations for law reforms are dealt with in the last Chapter.

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[52] 'Roberts Supports Legislative Broadening of 'Security', *Federal Securities Law Reports*, Number 1633, October 1994, 5.

[53] Cameron, A, 'The Wallis Report: Consumer Protection and Financial Sector Regulation', *The Australian Banker*, Vol 111. No.3, June 1997, 97.

[54] Cameron, A, note 53, 97.

[55] Cameron, A, note 53, 97.

CHAPTER 8

MAJOR FINDINGS AND RECENT DEVELOPMENTS

8.1 Introduction

This Chapter draws together the more significant findings from the analysis of the regulatory framework undertaken in Chapters 5, 6 and 7 which are relevant to the issue of investor protection. In summary, the findings are that gaps exist both in the Corporations Law and in the supervisory framework. These gaps have resulted in the majority of derivatives being unregulated by the Corporations Law and the majority of derivatives users and potential users being unregulated entities. Although investor protection provisions under the *Trade Practices Act 1974* and the Crimes Act assist in closing some gaps, a good proportion of them remains. These remaining gaps are also not filled by the prudential regulation of agencies which are mandated to supervise banks, State-based financial institutions, insurance companies and trustees of superannuation funds.

The more significant findings of this thesis are presented in paragraph 8.2 and their implications are explained in paragraph 8.3. It is a contention of this work that the existing system does not adequately protect investors trading in the OTC derivatives markets. Some of these findings are supported in recent final reports by the Companies and Securities Advisory Committee (CASAC) and Wallis Committee. Where this is so, it is indicated in the discussion on the relevant findings. A number of findings in this thesis, though supported by logic and by analysis, unfortunately were not discussed in CASAC's 'Regulation of On-exchange and OTC Derivatives Markets, Final Report', June 1997 (CASAC Final Report)[1] or in the Wallis Committee's Financial System Inquiry entitled 'Financial System Inquiry Final Report' (Wallis Final Report).[2]

Whilst there is commonality in some findings, there is not always a coincidence of views (between the proposals in this thesis on the one hand and those of CASAC and Wallis on the other hand nor between the views expressed by CASAC and those expressed by Wallis) as to what is an appropriate response to address the problems identified. This necessitates an evaluation on aspects of recent recommendations of the Wallis Committee[3] and of CASAC in ensuring investor protection. Where

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[1] Companies & Securities Advisory Committee, 'Regulation of On-exchange and OTC Derivatives Markets, Final Report', June 1997.(CASAC Final Report).

[2] Financial System Inquiry, *Financial System Inquiry Final Report,* Australian Government Publishing Service, March 1997 (Wallis Final Report).

[3] See Appendix 3 of this thesis.

relevant, the Commonwealth's response[4] to the Wallis Final Report is also discussed. The recommendations for law reform are located in the next chapter.

8.2 A summary of significant findings

8.2.1 Gaps in the Corporations Law

The examination of the Corporations Law in Chapter 5 of this thesis has revealed a number of regulatory gaps in Chapters 7 and 8 of the Corporations Law.[5] Most of the gaps are linked to the definitions of "securities" and "futures contracts". An OTC derivatives contract which is not within the rigid definition of "securities" in section 92 or "futures contract" in section 72 of the Corporations Law is outside the ambit of the Law, that is, such a contract is within the regulatory gap. It is not possible to list all the derivatives contracts that are unregulated by the Corporations Law, as there are thousands of different derivatives now in existence, and new derivatives instruments are continually being developed. Nevertheless, it is possible to classify unregulated derivatives contracts into three groups.

First, interest rate swaps, currency swaps, forward exchange rate contracts, and forward interest rate contracts to which a bank or a merchant bank is a party are unregulated. This group is by far the biggest class of unregulated OTC derivatives, as it accounts for about two thirds of the total derivatives market in Australia.[6] These contracts are unregulated because they are excluded from the definition of "futures contract" in paragraph 72(1)(d) of the Corporations Law.

Second, Chapter 8 agreements which are within a group of contracts prescribed under paragraph 72(1)(e) of the Corporations Law to be excluded contracts are also unregulated. This is not a significant group of OTC derivatives contracts because, as explained in Chapter 5 of this thesis, applications under paragraph 72(1)(e) are seldom made. This is mainly because paragraph 72(1)(e) is not useful to most applicants,

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[4] Costello, P, 'Reform of the Australian Financial System', a Statement by the Treasurer delivered at the House of Representatives, 2 September 1997 (Treasurer's Response to Wallis Committee) (http://www.treasury.gov.au/PressReleases/Treasurer/1997_0102_Statement.html)

[5] It is acknowledged that some of the gaps discussed in Chapter 5 are not new findings but have been discussed in literature on derivatives regulation for some years: for examples, see Australian Securities Commission, 'Draft Report On Over-The-Counter Derivatives Markets', 1993 (ASC DP); Australian Securities Commission, 'Report On Over-The-Counter Derivatives Markets', 1994 (ASC Final Report); Companies & Securities Advisory Committee, 'Regulation of the OTC Derivatives Market, Discussion Paper', 1995 (CASAC OTC DP).

[6] Reserve Bank of Australia, 'Survey of Derivatives Market Activity in Australia', Media Release No 95-21, 19 December 1995, Table 1. The calculation is made from the figures as at end March 1995 provided in Table 1. See Chapter 5 of this thesis.

being limited to products, while most applicants require exemptions for an entire market.[7]

Third, leaving aside those derivatives products excluded from the definition of "futures contracts referred to above,[8] a number of OTC derivatives now in existence cannot be classified as "securities" or "futures contracts" and are therefore unregulated by the Corporations Law. In particular, options may be singled out for mention. Their complexity and the wide range of option products may give rise to regulatory gaps.[9] Examples of options which are unregulated are the OTC equity option,[10] an OTC option over a share index,[11] an OTC compulsory cash settled option[12] and an OTC commodity option.[13] Arguably, interest rate swaps[14] - although not options - are also within the regulatory gap.

The first and third categories of unregulated derivatives listed in the preceding three paragraphs above were referred to in the CASAC Final Report and represent two of the four product based categories of OTC derivatives identified by CASAC.[15] The second category was not mentioned, although it should have been. Presumably, this is due to the fact that the contracts within paragraph 72(1)(e) is a very small group and may be considered as marginal. However, no identification was made by CASAC nor indeed by the Wallis Committee on the categories of OTC derivatives that fall within the regulatory gap.

8.2.2 Shortcomings of the Corporations Law regime arising from definitions

In addition to their accounting for regulatory gaps, several other conclusions may be drawn about the definitions in the Corporations Law and in particular, of the two key terms, "securities" and "futures contract".

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[7] Such applications are usually sought under section 1127 of the Corporations Law.
[8] These are contracts in paragraph 72(1)(d) and paragraph 72(1)(e) of the Corporations Law.
[9] Companies and Securities Advisory Committee, 'Law of Derivatives: An International Comparison', 1995 (CASAC International Comparison), 23.
[10] Mallesons Stephen Jaques pointed out that whether an interest rate swap is an adjustment contract and therefore a futures contract will depend on whether the swap contract is a standardised agreement. See legal analysis by Mallesons Stephen Jaques, in their submission to the ASC reprinted in Group of Thirty, Global Derivatives Study Group, 'Derivatives: Practices and Principles - Appendix II: Legal Enforceability: Survey of Nine Jurisdictions', Washington, 1993, Attachment A (Mallesons' submission to G30), paragraphs 1, 2 & 3.
[11] See legal analysis in Mallesons' submission to G30, note 10, Attachment A, paragraph 6.
[12] *Carragreen Currency Corporation Pty Ltd* v *Corporate Affairs Commission (NSW)*, (1987) 5 ACLC 148 (Carragreen Case), 159.
[13] Carragreen Case, note 11, 148.
[14] See legal analysis Mallesons' submission to G30, note 10, Attachment A, paragraph 4.
[15] CASAC Final Report, note 1, 25.

8.2.2.1 Dated and inflexible

The existing definitions of "securities" and "futures contract" are inappropriate in that they are dated and inflexible. While the definition of a "futures contract" in Chapter 8 would generally include forwards, swaps, futures and options, it is clear that the rigid statutory definition of "futures contract" has the effect of excluding a large number of existing contracts which would be commonly understood as "derivatives" contracts. This conclusion has been arrived at by the examination of key definitions carried out in Chapter 5 of this thesis. A major failing of these definitions is their inability to accommodate OTC derivatives which do not fall within the definitions. Possible examples of OTC derivatives within the regulatory gap have been cited in paragraph 8.2.1 above.

8.2.2.2 Complexity

The definitions of "securities" and "futures contract" are unduly complex and highly technical given that both sections 92 and 72 of the Corporations Law are built on several layers of definitions. It is beyond the scope of this thesis to elaborate here. However, one example is subsection 72(1) of the Corporations Law. Each of the four species of contract referred to in that subsection is a defined term in section 9 and the definition for each species is again dependent on other defined terms.

8.2.2.3 Definitions give rise to legal uncertainty

Some definitions in section 9 which relates to securities and futures contracts are problematic. For example, there is uncertainty over whether a "Chapter 8 right" as defined in section 55[16] of the Corporations Law would have the effect of rendering an option over an unenforceable contract, valid and enforceable. It is arguable that the language in section 55 permits an option over a contract which is unenforceable at common law or in equity to be enforceable.[17]

8.2.2.4 Underlying inconsistency in approach for excluding contracts from being a futures contract

Paragraph 72(1)(d) of the Corporations Law excludes four classes of contracts from being a futures contract if a bank is a counterparty. Two comments may be made in respect of these contracts from an investor protection perspective. First, there is no logical reason for discriminating one class of contracts from another. The selection of the four classes of contracts appears to be arbitrary given that there is a range of

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[16] Section 55 of the Corporations Law states that a "Chapter 8 right" is a right "whether or not enforceable at law or in equity".

[17] See Chapter 5 of this thesis for other examples, eg, paragraph 5.2.1.2.

derivatives contracts that are traded by banks. This, too, was the conclusion of CASAC when it opined that paragraph 72(1)(d) of the Corporations Law:

> "may not accommodate market developments. They only cover certain swaps and forward rate agreements. For instance, commodity swaps and equity swaps fall outside the exclusions and may be futures contracts regulated under Chapter 8. Yet they satisfy the rationale for exclusion as, in practice, they are only traded between sophisticated parties and therefore do not raise investor protection concerns."[18]

Second, it is also unclear why banks are singled out for preferential treatment, particularly as seen from the discussion in Chapter 7 of this thesis, that prudential regulation by the Reserve Bank of Australia (RBA) is no substitute for the sanctions provisions in the Corporations Law. Prudential regulation could not be used as a substitute for the regime in Chapters 7 and 8 of the Corporations Law because it applies only to one party to the transaction, namely the bank and not to both parties. As such it has no application to counterparties to OTC derivatives contracts unless the counterparties are themselves regulated entities. Further, the focus of prudential regulation is on financial safety of regulatees and does not deal with conduct regulation, such as those found in the sanctions regime of Chapters 7 and 8 of the Corporations Law. Thus it is to be concluded that prudential regulation is no substitute for filling the gaps in the Corporations Law regime.

8.2.3 Gaps and inconsistencies in the sanctions regimes of the Corporations Law

A comparison between the sanctions provisions in Chapter 7 and those of Chapter 8 of the Corporations Law reveals inconsistencies which also expose gaps in investor protection. Undesirable market conduct such as hawking[19] applies only to securities and there is no equivalent provision which forbids the hawking of futures contracts or other forms of OTC derivatives contracts. Given that securities are in the minority group of OTC derivatives contracts, it follows that a regulatory gap exists as the prohibition against hawking does not apply to the majority of all OTC derivatives contracts.

Likewise, there is no provision in Chapter 7 of the Corporations Law which is equivalent to section 1264 which prohibits fraud by a broker on its clients. This is an anomaly and constitutes a regulatory gap in the securities sanctions regime in Chapter 7. Another provision in Chapter 8 of the Corporations Law which is not mirrored in

[18] CASAC International Comparison, note 9, 21-22.
[19] Section 1078 of the Corporations Law.

the securities sanction regime is section 1258. This section requires dealings by futures broker on behalf of others to be made on exchange or on an exempt market.

8.2.4 Gaps in the sanctions regime which cannot be filled by the Trade Practices Act 1974 (Cth) and Crimes Act 1900 (NSW)

Derivatives contracts falling within the regulatory gap of the Corporations Law regime may nevertheless be regulated by the sanctions provisions of the ***Trade Practices Act 1974*** (TPA) and the ***Crimes Act 1900*** of New South Wales (Crimes Act) if the conduct prohibited by the Corporations Law is also forbidden either by the TPA or the Crimes Act. However, this study has demonstrated that in about half of the securities and futures offences[20] examined in Chapter 6 of this thesis, no parallel provisions exist under the Crimes Act or the TPA. The unregulated conduct includes those market practices proscribed under sections 1001 and 1263 (dissemination of information), section 1078 (hawking of securities), sections 1002G and 1013 (insider trading in relation to securities), sections 1253 and 1254 (insider dealing in futures contract), sections 1258 (dealings by futures broker on behalf of others) and 1266 (sequence of transmission and execution). It is to be concluded that in respect of OTC derivatives contracts which are in the regulatory gap, there is presently no sanctions against such undesirable practices as hawking, insider trading or dealing, runs, bucketing and frontrunning.

The more serious market conduct such as market manipulation,[21] false trading and market rigging,[22] false or misleading statement,[23] fraudulently inducing dealing[24] and fraud[25] are largely also prohibited by either the TPA or the Crimes Act and in certain types of conduct, by both. It has been established in Chapter 6 that, despite the existence of parallel provisions in the TPA and Crimes Act, the protection afforded by these general laws to investors is not as effective as the equivalent provisions under the Corporations Law for several reasons.

First, mens rea is a necessary ingredient of the relevant offences[26] under the Crimes Act whereas many of the offences under the Corporations Law are strict liability offences,[27] which means all that a prosecutor is required to prove to secure a

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[20] These refer to offences under Chapters 7 and 8 of the Corporations Law.
[21] Prohibited by sections 997 and 1259 of the Corporations Law.
[22] Prohibited by sections 998 and 1260 of the Corporations Law.
[23] Prohibited by sections 999 and 1261 of the Corporations Law.
[24] Prohibited by sections 1000 and 1262 of the Corporations Law.
[25] Prohibited by section 1264 of the Corporations Law.
[26] Sections 178BA, 178BB and 185A of the Crimes Act.
[27] In Chapter 8 of the Corporations Law, sections 1258, 1259, 1263, 1266 and arguably 1260 are strict liability offences. Sections 1261, 1262 and 1264 are offences requiring proof of mens rea.

conviction is the actus reus. The requirement that culpability be established makes it more difficult to secure a conviction under the Crimes Act and renders the Crimes Act sanctions less effective.

Second, as the discussion in Chapter 6 of this thesis in relation to subsection 45(2) TPA shows, the provisions of the Crimes Act and the TPA are generally not as wide as the equivalent Corporations Law provisions.

Third, as again demonstrated in the discussion in Chapter 6 in relation to section 46 TPA whether a particular provision in the general law could be used as a substitute for similar provisions in Corporations Law will ultimately depend on the interpretation provided by the courts. This is because the general laws are not tailored to derivatives markets and are uncertain as to the scope of their operation.

8.2.5 Gaps in the supervisory framework

Finally, the findings in Chapter 7 of this thesis on investor protection offered by the regulatory agencies should be mentioned. The main findings are that:

1. Gaps exist in the supervisory structure. They arise because the combined regulatory surveillance of these agencies, prudential and non prudential, does not extend to all the participants in the OTC derivatives markets, but only to those within the jurisdiction of each regulator. Only a handful of industries are regulated, these being banks, insurance companies, superannuation funds and State-based financial institutions. An important consequence of this is that the majority of derivatives participants or potential participants are not subject to supervision by any regulator. For example, a review of the public companies listed on the Australian Stock Exchange indicates that very few of them belong to a regulated industry. A transaction to which a regulated entity is a party does not render the transaction a regulated transaction nor does it render a counterparty (unless it is an institution subject to prudential regulation) a regulated entity, subject to the supervision of a prudential regulator. These regulators are powerless to require that such a counterparty observe prudential standards so that equity investors and other stakeholders in that counterparty would enjoy similar protection from risk of loss.

2. Prudential regulation does not assist in filling the regulatory gaps in the Corporations Law. Such regulation focuses on financial safety of the institutions regulated and is aimed at protecting markets and funds from credit

and systemic risks.[28] While prudential regulation would protect equity investors by making it more difficult for a company to fail, it does not generally deal directly with investor protection in the sense that it does not proscribe undesirable conduct in the financial markets. As such prudential regulation carried out by the RBA, the Insurance and Superannuation Commission (ISC) and the Australian Financial Institutions Commission (AFIC) is no substitute for filling the gaps in the Corporations Law regime.

3. In respect of institutions which are prudentially regulated, there is no uniformity in the standards of regulation which are applied. Given that similar products are often sold by different institutions, the different regulatory treatment applying to products with essentially the same characteristics means that investors would receive different standards of protection.[29] For example, in the area of sales and investment advice, it is noted that advising on or selling of securities or superannuation is controlled under a licensing regime in the Corporations Law[30] and advising on or selling of life products is subject to a separate regime in the Life Code of Practice but there is no similar regime in place for sales and advice on bank products.[31] This constitutes a "gap" in investor protection.

The Wallis Committee, noting the negative consequences of the present fragmented arrangements,[32] sought to have the problem addressed in its proposals for two universal regulators. Its recommendations on regulators are evaluated in paragraph 8.4 below.

8.3 Major implications of findings

The existence of lacunae in the legal structure has serious implications for investors, particularly the retail investors since this group is generally less informed or less able to protect itself. The gaps in the legal and supervisory frameworks give rise to the following results:

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[28] International Organisation of Securities Commission, 'Regulation of Derivative Markets, Products and Financial Intermediaries: Collated Summary of Responses to Common Framework of Analysis and Cross Regulatory Summary Chart', October 1993 (IOSC 1993), 9.

[29] "Roberts Supports Legislative Broadening of 'Security'", Federal Securities Law Reports, Number 1633, October 1994, 5.

[30] Cameron, A, 'The Wallis Report: Consumer Protection and Financial Sector Regulation', The Australian Banker, Vol 111. No.3, June 1997, 97.

[31] Cameron, A, note 30, 97.

[32] Wallis Final Report, note 2, 243.

1. Unregulated products (that is, products which are neither securities nor futures or which are not brought under the Corporations Law regime by the deeming provisions in sections 72A and 92A);

2. Unregulated entities (that is, those organisations which are not subject to prudential regulation); and

3. Increased trading risks for investors, due to an increase in market, credit and legal risks as a direct consequence of the regulatory gaps.

8.3.1 Unregulated products

Deficiencies in the legal structure leave investors unprotected in two significant areas where such protection has long been a feature of the futures and securities markets. First, they are not protected against unfair market practices; second, they are also not protected in their dealings with intermediaries since derivatives dealers and brokers who buy or sell unregulated products need not comply with such statutory requirements as disclosure, fidelity funds, licensing or suitability requirements and third, they need not be subject to the requirement that all futures contracts must be traded on authorised futures markets or on exempt futures markets.

8.3.1.1 Sanctions regime

A major implication of regulatory gaps is that they provide opportunities for the unscrupulous operators trading in unregulated products in the OTC derivatives markets. In the absence of statutory safeguards, these operators are in a position to carry out a number of sharp market practices[33] at the expense of investors. They could do so without fear of prosecution since these practices do not constitute an offence under the existing laws. Such undesirable practices (for example, insider trading) could cause financial losses to investors and erode investor confidence.

8.3.1.2 Intermediaries

Another major implication for investors is the inapplicability of statutory safeguards which the Corporations Law imposes on intermediaries. These safeguards include licensing of intermediaries; complying with disclosure requirements and the suitability rule; availability of fidelity funds to compensate an investor who has suffered loss due to the defalcation of an intermediary and the requirement that all futures contracts must be traded on authorised futures markets or on exempt futures markets.

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[33] These includes insider trading or dealing, hawking, bucketing and frontrunning.

Because derivatives dealers and brokers who buy or sell unregulated products need not comply with such statutory requirements investors trading in unregulated products do not enjoy these protection.

For instance, being outside the Corporations Law framework, unregulated products could be sold by any person or company, free from the licensing and other protective requirements of the Corporations Law.[34] As seen in paragraph 4.3.4.2, licensing is an important regulatory tool which provides effective investor protection. A licensing regime ensures, among other things, that only suitable persons are given a permit to deal or to provide advice; that brokers and dealers are required to keep client moneys separate from their own;[35] and that fidelity funds are available to compensate investors who have suffered pecuniary loss due to a defalcation or fraudulent misuse of the investor's property.[36] Licensing also provides the regulator with a measure of control over the good conduct of the licensees. Such protection is not available to investors trading in unregulated products. Licensing for all derivatives products is supported by the Wallis Committee and by CASAC.[37]

Arguably, another example of a safeguard which is not available to investors trading in unregulated products is the "suitability requirement" which is imposed by the Corporations Law on securities advisers pursuant to section 851 of the Corporations Law. Currently no similar requirements to ensure suitability is imposed on futures advisers. This rule does not require the adviser to provide a personal recommendation in any particular case or, if the adviser does so, to provide the best advice.[38] However, it does require the dealer or adviser to make reasonable enquiries about its client's financial situation before giving advice or recommendation to the client or investor.[39] It is submitted that such a rule places an onerous burden on the dealers and advisers. A well designed disclosure statement provides the client with all necessary information and a range of remedies is available to the client at common law and under consumer and criminal laws if the broker or dealer misrepresents, or provides negligent advice or is in breach of his/her fiduciary duties. From an investor's point of view, a "know your client" rule does not add much more protection than the

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[34] The prohibition in section 1142 and 1143 of the Corporations Law against persons (other than exempt brokers or advisers) acting as futures brokers or advisers without a licence is confined only to futures contracts. Similarly, the corresponding provisions in sections 780 and 781 prohibiting a person from carrying on as a dealer in securities or as an investment adviser are applicable only to securities: see section 77 of the Corporations Law.

[35] See section 866 (in relation to securities) and section 1209 (in relation to futures contracts).

[36] See Part 7.9 and Part 8.6 of the Corporations Law.

[37] Recommendation 13, Wallis Final Report, note 2, and Recommendations 20, 21, 22 and 24, CASAC Final Report, note 1.

[38] CASAC Final Report, note 1, 154.

[39] CASAC Final Report, note 1, 160.

information provided in a disclosure statement. On the other hand, it may increase the cost of transactions.

8.3.1.3 Derivatives market authorisation

The current regulatory arrangement requires that all futures contracts be traded only in an authorised market or in an exempt futures market.[40] The mechanism of authorisation provides the regulator with the means of ensuring investor protection by controlling the application process so that only those applicants who meet the regulator's criteria are granted the authorisation. A regulator could, for example, require that the applicant demonstrate it is capable of conducting the market in a fair and orderly manner, that any price formation process is reliable, that any information provided on that market cannot be interfered with and that there are market mechanisms to guard against any misleading, manipulative or abusive conduct.[41] Such a mechanism provides a regulator with a valuable opportunity of rejecting those who fail to meet the criteria for investor protection.

With unregulated products, such a mechanism is not available to the regulator because there is no legal requirement for participants wishing to trade in unregulated market products to make an application for trading. As the mechanism does not apply to market makers of unregulated products, investors trading in these products are denied a significant safeguard which could enhance their protection.

The Wallis Committee in its Recommendation 23, proposed that there be authorisation for appropriately licensed intermediaries to conduct OTC markets. It recommended that the CFSC should have the power to impose any condition necessary to ensure that the market is conducted fairly and that operational risks are contained. CASAC's recommendation[42] is wider in that its suggestion for authorisation is not confined to intermediaries but to all participants in the derivatives market.[43] It is submitted that the CASAC recommendation has more merit as it targets all participants and not just intermediaries and also targets all derivatives contracts and not just futures contracts as is the position under the current regulatory arrangement.

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[40] Section 1123 of the Corporations Law prohibit the conduct or establishment of an unauthorised futures market.
[41] CASAC Final Report, note 1, 77-78.
[42] See Recommendation 7, CASAC Final Report, note 1, 80.
[43] Recommendation 7 provides that a person should be prohibited from conducting a derivatives market unless authorised.

8.3.2 Unregulated entities

Unregulated entities arise from the incomplete coverage of the OTC derivatives markets by prudential regulators. It has been pointed out in Chapter 7 of this thesis that prudential regulation is narrow in its focus for it extends only to the institutions which are so regulated. Presently, institutions subject to prudential regulation are banks, state based financial institutions, superannuation trustees and insurance companies. An institution or entity not within one of these categories is not prudentially regulated. Unregulated entities have implications for investor protection.

Imposing prudential regulation on selected types of institutions and not on all others creates an unlevel playing field. Such a situation could, for instance, provide opportunities for new entities to be formed specifically to compete with regulated entities. The new entities could sell similar products and services free from prudential or statutory requirements. This will encourage regulatory arbitrage and put regulated entities at a competitive disadvantage.

Increasingly also, the trend in recent years is for the ordinary members of the public (which form the bulk of the population) to invest in shares of public listed companies. Some public listed companies have a wide spread of shareholders comprising mainly of the "mums and dads" and it is conceivable that they could lose their entire investment in a particular company in the event that company imprudently gambles and incurs huge losses on OTC or on exchange derivatives. Prudential regulation helps to lower the risk of financial loss to equity investors.

The Wallis Committee's recommendation of a single regulator fails to address this gap. It proposes that the responsibility for prudential regulation, currently within the purview of individual prudential regulators such as the RBA and the ISC, be transferred to a single regulator, referred to in the Wallis Final Report as the Australian Prudential Regulation Commission (APRC). This recommendation fails to remedy the regulatory gap identified in Chapter 7 of this thesis. It does not call for an expansion of the regulatory boundary of the APRC so as to bring other entities trading in derivatives under the supervision of the prudential regulator. The Wallis Committee has argued[44] that "(s)ince the objective of regulation is to increase the probability of a promise being honoured, and since this relates to the creditworthiness of the promisor, it follows that the focus of regulation must remain on the promising entity as a whole". In other words, the Wallis recommendation is for prudential regulation to continue to

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[44] Wallis Final Report, note 2, 303.

apply to derivatives suppliers, namely, the banks, insurance companies and superannuation trustees. The need to supervise counterparties has been ignored.

It may be argued, in support of the Wallis recommendation, that there is a wide choice of investments available to the investor (he or she could pick any of the hundreds of public listed companies) and that in making the choice to purchase shares in one but not the others, the investor clearly accepts the risk of loss which is inherent in making an investment decision.[45] It is submitted, with respect, that such a stance would discriminate against certain sections of the investing public (ie, investors in institutions not prudentially regulated) and would be contrary to a key finding of the Wallis Committee (in its discussions on the philosophy of financial regulation) which recognises that "specialised regulation is required to ensure that the market participants act with integrity and that consumers are protected."[46]

In Chapter 3 of this thesis, it has been pointed out that derivatives, unlike the more traditional financial products, have a tendency to increase the risk profile of market participants.[47] As the enhanced level of risk is associated with all derivatives participants, and not just with the target group of entities - banks, superannuation funds, insurance companies or State based financial institutions - investors dealing with or investing in entities outside of this target group are as much entitled to regulatory protection as any other investor or consumer.

CASAC's Final Report, while recognising the need for prudential regulation for OTC market makers[48] has recommended merely that these market makers be required to have a minimum satisfactory risk management system. No recommendation was made for imposing the more traditional form of prudential controls such as capital adequacy requirements, liquidity requirements or limits on derivatives trading for non-hedging purposes. Additionally, CASAC specifically does not recommend any prudential regulation for wholesale end users.[49]

The Commonwealth Treasurer, in his response to the Wallis Final Report, endorsed the Wallis Committee's recommendation to establish an Australian Prudential Regulation Authority (APRA) "to prudentially supervise deposit taking institutions,

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[45] See generally the Wallis Committee's argument for regulating superannuation funds but not unit trusts and other managed funds in Wallis Final Report, note 2, 305.
[46] Wallis Final Report, note 2, 175.
[47] See Chapter 3 of this thesis, paragraph 3.6.
[48] CASAC Final Report, note 1, Recommendation 31.
[49] CASAC Final Report, note 1, 135.

life and general insurance companies and superannuation funds".[50] Unfortunately, no proposals were evident either in the Treasurer's Statement or in the Details of Measures[51] to address the regulatory anomaly in investor protection by extending the surveillance net of regulatory agencies beyond the current jurisdictional boundaries.

The lack of prudential controls over unregulated entities has left one section of the investment community unprotected. Shareholders and other stakeholders of unregulated entities are deprived of the safe haven (from the risk of loss) which prudential regulation provides. It is submitted that prudential regulation should apply to all entities dealing with retail investors who trade in the derivatives markets and to wholesale as well as end-users which are public listed companies. To preserve the status quo would be to perpetuate a discriminatory policy with investors/depositors in banks and other regulated institutions enjoying greater degree of protection when compared with investors in unregulated institutions.

8.3.3 Implications of gaps in the Corporations Law on trading risks

Another implication of gaps in the legal structure is that they increase trading risks. Three of the most important risks facing an investor are market, credit and legal risks. These risks were discussed in paragraphs 5.4, 5.5 and 5.6 of this thesis.

8.3.3.1 Market risks

It was argued in Chapter 5 of this thesis that regulatory gaps could increase market risks. They provide an environment which is conducive to unfair and undesirable market practices because the statutory safeguards under the Corporations Law regime to protect investors would not be available. This scenario could increase market risks in two ways. First, prices of contracts subject to manipulation or unfair practices could be volatile, giving rise to market risks. Second, a market which is plagued by undesirable conduct could lead to a lack of investor confidence which in turn could result in lower volume of trading, and thus causing an increase in the price of derivatives contracts, contributing to volatility.

8.3.3.2 Credit risks

The view that credit risks are enhanced by the "gap" or failure of the Corporations Law expressly to recognise netting arrangements has been canvassed in Chapter 5 of this thesis. Under the provisions of the Corporations Law[52] and the *Bankruptcy Act*

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[50] Treasurer's response to Wallis Committee, note 4.
[51] Costello, P, 'Reform of the Australian Financial System: Details of Measures', additional document tabled in association with the Statement by the Treasurer delivered at the House of Representatives, 2 September 1997 (Treasurer's Details accompanying his response to Wallis Committee).
[52] See section 588FA.

1966, any contractual netting agreement is thought to be ineffective in the event of the insolvency of a counterparty and this will have a significant effect on credit risks. Credit risks are often reflected in the higher cost of a product, making it less competitive.

CASAC's Netting Sub Committee, in its Final Report on netting,[53] recommended legislation[54] to clarify the law of netting which would put beyond doubt the legal effectiveness of bilateral close out netting and market netting arrangements. Both the Wallis Committee[55] and CASAC[56] supported the enactment of facilitative netting legislation. The proposed enactment appears fair and equitable and is a step in the right direction. Such an Act will ensure the enforceability of netting contracts under the *Banking Act 1959, the Life Insurance Act 1995* and generally the *Bankruptcy Act 1966* and the Corporations Law.[57] To prevent fraud, the provisions on voidable transactions such as sections 120,[58] 121[59] and 122[60] of the *Bankruptcy Act 1966* and Part 5.7B Division 2 of the Corporations Law[61] have been preserved.[62] The proposed Act has the advantage of balancing protection for creditors of insolvent entities (by making netting arrangements invalid in circumstances which may be considered as fraudulent) with protection for investors of entities which trade in the derivatives markets (by recognising netting contracts in all other situations).

The proposal by CASAC for a new enactment to be entitled "the Close Out and Market Netting Act" is supported.

8.3.3.3 Legal risks

More than market or credit risks, the regulatory gaps give rise to legal risks, criminal as well as civil. Criminal liability may be incurred because the participants unwittingly conducted unauthorised futures markets which conduct of unauthorised futures markets is prohibited by section 1123 of the Corporations Law.[63] Criminal liability may also arise because the protection given by sections 778 and 1141 is limited to all

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[53] Companies & Securities Advisory Committee, Netting Sub-Committee, 'Netting in Financial Markets Transactions, Final Report', June 1997 (CASAC Netting Subcommittee Final Report).
[54] The proposed enactment is the Close Out and Market Netting Act.
[55] Recommendation 59.
[56] CASAC Final Report, note 1, paragraph 8.120.
[57] See section 2.1 of the proposed Close Out and Market Netting Act.
[58] Avoidance of voluntary and marriage settlement
[59] Fraudulent dispositions.
[60] Avoidance of preference.
[61] Voidable transactions.
[62] See the 'Explanatory Notes to the Proposed Act' in CASAC Netting Subcommittee Final Report, note 53, 11.
[63] The penalty is 200 penalty units or 5 years imprisonment or both.

futures contracts and option contracts traded on a stock exchange or an exempt market.[64] At the same time, the parties to such derivatives contracts could incur opportunity costs as no hedging protection could be given or profit could be made due to their unenforceablility because of illegality. As a consequence of legal cases such as *Westdeutsche Landersbank Girozentrale v The Council of the London Borough of Islington* (1993) 2 BLR 159 and *David Securities Pty Ltd v Commonwealth Bank of Australia* (1990) 93 ALR 271, it is unlikely that losses will be incurred on the grounds of illegality or ultra vires. Arguably, any monies paid on an illegal contract could be recoverable as a mistake of law. Likewise monies paid under an ultra vires contract may be recoverable on the basis that as an ultra vires contract is a void contract no consideration has been given or alternatively it was entered into under a mistake of fact or law, and therefore recoverable. However, the operation of insolvency rules is still of concern since they could cause loss to a participant through the application of the doctrines of undue preference or relation back. This was discussed in paragraph 5.6.2(b) of this thesis.

(a) Illegality due to unauthorised futures market

Arguably, the issue of illegality may be addressed, in relation to unauthorised futures markets, by clarifying the law to provide legal certainty as to what constitutes a futures contract. It may be recalled that the reason why section 1123 may be contravened is due to the wide definitions of "futures contract" and "futures markets" in the Corporations Law. One way of addressing this problem is to redefine "futures contract" and "futures markets" so that contracts not intended to be subject to the stringent rules of the derivatives regime will be automatically exempt. These include treasury transactions by the same corporate group and cross trading between collective investment funds having a common fund manager.[65] CASAC's recommendation for a new definition of "derivatives market" has much merit in that a market, exchange or other place at which derivatives are regularly acquired or disposed of, does not automatically become a derivatives market. However, it also raises some concerns as no market will be deemed to be a "derivatives market" unless "the ASC, in the public interest, designates the activity as a derivatives market."[66] The ASC may not be aware of all the activities that have the potential to constitute a derivatives market and being unaware, it would not have considered whether an activity ought or ought not be classified as a

[64] See discussions on regulatory gaps and legal risks in Chapter 5 of this thesis.
[65] CASAC Netting Subcommittee Final Report, note 53, 70.
[66] CASAC Netting Subcommittee Final Report, note 53, 80.

derivatives market. It is suggested that some refinement of the definition may be appropriate to cater for this concern.

Another way of overcoming the problem on unauthorised markets is to remove the exclusivity of the interim safe harbour policy to sophisticated participants so that non sophisticated participants may also be granted exempt market status. The problem on unauthorised markets has been circumvented, in part, by the ASC's Policy Statement 70 which allows sophisticated participants to seek exemptions under section 1127 from the Minister. No provision has been made for other participants. Given that the number and categories of providers of derivatives market facilities have continued to be on the rise, a wider solution needs to be found. If access to the interim safe harbour is allowed to non sophisticated participants, they may also be granted exempt market status. The extension of the ASC Policy Statement 70 may not a viable alternative since the policy reasons for confining exemptions to sophisticated players remain valid. The participation by retail investors in OTC markets raises complex investor protection issues[67] and the granting of exempt market declarations to retail investors may compromise the level of protection which is required for this group of investors.

(b) Illegality due to contravention of gaming and wagering laws

The second cause of illegality is the likelihood of some OTC derivatives contracts contravening the States' gaming and wagering legislation since all OTC derivatives contracts (other than certain contracts traded on exempt markets) as well as some on exchange derivatives contracts are not saved from illegality by sections 778 and 1141.[68] The CASAC Final Report recommended that all transactions on the OTC derivatives markets should be specifically excluded from gaming and wagering legislation.[69] This recommendation, if adopted, would eliminated the anomaly which was noted in Chapter 5 of this thesis. There is no reason why such a discriminatory policy should be retained. The rationale which led to the exclusion of those derivatives contracts referred to in sections 778 and 1141 apply equally to other classes of derivatives contracts.

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[67] Australian Securities Commission, 'Policy Statement 70: Exempt Futures Markets', 1993, paragraph 34.

[68] This is because the current position is that sections 778 and 1141 make valid and enforceable only two classes of contracts, ie, all option contracts traded on a stock exchange or an exempt market and all futures contracts traded on an exchange or an exempt market, notwithstanding that such a contract may infringe gaming laws of the States.

[69] CASAC Final Report, note 1, 208.

(c) Unenforceability of contract due to the ultra vires doctrine

The ultra vires problem raises another thorny policy issue. The ultra vires principle has been used by the courts to protect beneficiaries of or shareholders in entities such as trusts, certain corporations[70] and building societies against misuse or misapplication of funds in respect of unauthorised transactions. In relation to derivatives contracts, the operation of this legal doctrine has been at the expense of derivatives participants. This stems from the fact that a derivatives transaction is a zero sum game. If one party gains, the other will invariably lose a corresponding amount or at least suffer opportunity costs in having to forego an amount which would have been paid to it had the contract been intra vires. By voiding a contract on the basis that it is ultra vires, the law would appear to be an unfair arbiter, favouring the beneficiaries of a trust to the detriment of derivatives participants.

CASAC[71] formulated five possible policy options to deal with trusts which have no power to enter into derivatives contracts. CASAC's views are that entities which are prudentially regulated should not be allowed to rely on the doctrine and that in all other cases, it advocated a public register system whereby entities which have a restriction on their capacity to enter into derivatives transactions should identify themselves on a public register.[72] Any entity not on the register will be deemed in law to have full powers to enter into such contracts and any entity on the register will be deemed to have its powers restricted to the extent the restriction has been identified.[73] However, it has yet to arrive at a concluded view. It considered that the ultra vires issue created considerable policy problems which go beyond derivatives and that the matter could be the subject of a further review.[74]

CASAC's proposals, if carried out, will be a costly exercise as it would entail setting up a system, presumably computerised, whereby the public will be provided with the facility to search. The costs involved in setting up the system, and in making it readily accessible to a searcher may be very high. While it is true that the operation of the ultra vires principle is not confined to derivatives contracts, it is submitted that the issue is not perhaps as large as is

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[70] The corporations not exempted from the ultra vires rule have been identified in Chapter 3 of this thesis.
[71] CASAC Final Report, note 1, 205-206.
[72] CASAC Final Report, note 1, 207.
[73] CASAC Final Report, note 1, 207.
[74] CASAC Final Report, note 1, 207.

thought. The main problem is the effects of the doctrine on derivatives transactions which, in view of the often enormous size of individual transactions, could raise the spectre of a systemic crisis in the event of a failure of an entity. It is contended that the concern should therefore be focussed only on derivatives. Although other transactions may be affected by ultra vires, they do not create special concerns and accordingly should be left untouched.

(d) Unenforceabity of contract due to the operation of insolvency laws

The role of netting in lowering the risk of loss due to insolvency has been discussed in paragraph 8.3.3.2 above. If legal recognition is given to netting arrangements, as proposed by CASAC, most contracts will be enforceable notwithstanding the insolvency of a counterparty.

8.3.4 Unsuitable regulatory framework

Another major implication of the findings, as evident from the analysis in Chapters 5, 6 and 7, is that the regulatory structure is unsuited for regulating OTC financial derivatives. Derivatives are regulated through a bifurcated structure, namely:

- product regulation under the Corporations Law; and
- institutional regulation through prudential regulators.

The unsuitability of the Corporations Law regime is discussed in paragraph 8.3.4.1 while the shortcomings of institutional regulation are explained in paragraph 8.3.4.2. An evaluation of the Wallis Committee's recommendations for two national regulators are evaluated in paragraph 8.4.

To the bifurcated regulatory structure, a third source of regulation may be added. As noted previously, the general consumer and criminal laws are also of relevance. To the extent that such general laws govern the conduct of derivatives participants, they may be considered as forming a part of the regulatory structure for derivatives. However, their role in regulating derivatives is merely incidental to their wider functions in regulating, on a national or State basis, the criminal activities in the States or the anti-competitive and other undesirable activities which offend against consumer protection. These laws are a good supplement to the current regulatory regime for derivatives transactions mainly because of the deficiencies in the Corporations Law but will assume less significance once the regulatory gaps have been addressed. For that reason, it is not proposed that the general laws be considered further.

A further consequence of a split regime is that it gives rise to the anomalies and inconsistencies which were highlighted by the comparative table in Chapter 6 of this thesis and which were referred to in paragraph 8.2.3.

8.3.4.1 Inappropriateness of the Corporations Law structure

The regulation under the Corporations Law is divided into regulation for securities under Chapter 7 and regulation for futures contracts under Chapter 8. Such an arrangement is inappropriate because Chapter 7 is not designed to regulate derivatives, but securities, which are deemed an "underlying" asset. However, in the absence of specific derivatives regulation, Chapter 7 has been included in this thesis as part of the regulatory framework because two classes of contracts within the definition of "securities" are derivatives contracts. These are "prescribed interest" and "an option contract".

In Chapter 3 of this thesis, reference was made to four broad groups of derivatives contracts - options, forwards, swaps and futures contracts. The main reason why the current structure is considered deficient is because it fails to cover all derivatives products. An appropriate derivatives regime should cover these four classes of derivatives contracts, whether exchange traded or OTC.

The Wallis Committee, in Recommendation 19, has proposed to replace the current securities and futures law by a single regime to cover "financial products", a term which would include both securities and futures contracts. Under this proposal, there would be no separate regime for regulating stocks, shares and bonds nor will there be a regime for futures contracts. The regulation for securities will be subsumed under and merged with the regulation for financial products which includes derivatives. It is submitted that a merger would be inappropriate primarily because there is an important difference between securities and derivatives products in the function they perform, the former being capital fund raising instruments while derivatives are risks management instruments. As such they should be regulated separately. A single regime would bring about a regulatory "misfit" as there are areas in which the securities regime will not apply to derivatives and vice versa.

First, because the risks in derivatives are longer term than those for securities, derivatives clearing arrangements (but not securities clearing arrangements) need to deal with the longer term risks encountered in derivatives.[75] In the on exchange derivatives markets, these risks are dealt with by marking the contracts to market and

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[75] CASAC Final Report, note 1, 48-49.

the collection of margins daily. This mechanism to control risks would not be applicable to securities trading where the investor's financial obligations are usually fully discharged on settlement date - which occurs within days after the shares are bought or sold - by payment of the contract price in full or by delivery.

Second, the requirement for a prospectus as a means of ensuring a level playing field for potential buyers of shares, would not be relevant to an issue of derivatives contracts. In its Final Report on 'Regulation of On-exchange and OTC Derivatives Markets' released in June 1997, CASAC has expressed the view that prospectuses are justifiable for securities on the grounds that the issuer has intimate knowledge of the business of the company and investors are entitled to be informed as regards the prospects of the company in connection with primary issues of securities.[76] However, it pointed out that derivatives are derived from an underlying asset and information of the underlying may not be within the knowledge of the issuer.[77] A "one size fit" regime, if applied to both derivatives and securities, may have the effect of requiring prospectuses to be issued for derivatives. This would be inappropriate, although a disclosure statement may be useful for most derivatives.

Third, it would be inappropriate to apply uniform disclosure rules to both derivatives and securities. One of the major functions of disclosure is to ensure that the investors are aware of the risks and as seen above and in Chapter 3 of this thesis, the risk profile for derivatives[78] differs substantially from that of securities and other capital market instruments. As the risks attendant on securities are different from those of derivatives, a separate risk disclosure regime should apply.[79]

Fourth, the rules for transfer of title are applicable for marketable securities but not for derivatives unless the derivatives contracts involve physical delivery. It is the essence of a securities contract that there would be a transfer of title to the securities from the seller to the buyer and detailed rules are provided in Chapter 7 of the Corporations Law to cater for such transfer of title, particularly in Part 7.13 of the Law. Similar rules are not necessary for derivatives as they do not generally involve physical delivery and therefore a transfer of title.

Fifth, in relation to licensing requirements, there have been reservations on the appropriateness of a single licensing regime for both securities and derivatives. The

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[76] CASAC Final Report, note 1, 49.
[77] CASAC Final Report, note 1, 49.
[78] To recapitulate, derivatives are generally for longer term and the ability of the investors to leverage increases the risks.
[79] CASAC Final Report, note 1, 49.

concern is that a single licence would authorise a dealer to transact both securities and derivatives and that this would be inappropriate where the licence holder is familiar only with one product and not the other.[80] It is submitted that although this is a valid point, a single licensing regime could still apply either by ensuring that a licence is granted to those who exhibit a sound knowledge of both derivatives and securities or alternatively by providing for separate classes of licences, with those qualified for securities granted a licence limited to dealing with securities and those proficient in derivatives given a licence limited to derivatives.

It is submitted that a more appropriate arrangement would be to have Chapter 7 of the Corporations Law confined solely to securities which are not derivatives and have Chapter 8 of the Corporations Law, which deals with futures contracts, expanded to govern all types of derivatives contracts including prescribed interests and an option contract over securities which are currently within the definition of securities.

8.3.4.2 Deficiencies in institutional regulation

The finding that the combined jurisdiction of the regulators has left gaps in the supervisory net is of concern to investors. This has allowed some participants in the derivatives markets to trade in derivatives contracts, unsupervised. The Wallis Final Report contains several major recommendations which the Committee hoped would "maximise public certainty as to the scope of financial safety regulation".[81] The Committee's proposals for the establishment of two new regulators are examined in paragraph 8.4 below to determine their ability to fill up the gaps and provide adequate protection to investors.

The Wallis Final Report was the initiative of the Commonwealth Treasurer, the Hon Peter Costello MP, who in June 1996, established the Financial Systems Inquiry under the chairmanship of Mr Stan Wallis to provide a stocktake of the results arising from the deregulation of the financial markets since the early 1980s and to make recommendations for possible further improvements to the regulatory arrangements so as to ensure an efficient, responsive, competitive and flexible financial system.[82]

Following the Wallis Final Report, CASAC,[83] whose functions are to advise the Minister and to make recommendations about any matter in connection with, inter alia, securities or the futures industry and a proposal for improving the efficiency of the

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[80] CASAC Final Report, note 1, 49.
[81] Wallis Final Report, note 2, 22.
[82] Wallis Final Report, note 2, vii.
[83] CASAC was established under Part 9 of the *Australian Securities Commission Act 1989* (Cth).

securities markets or futures markets,[84] published the CASAC Final Report. While the Wallis Final Report provides the broad outline or 'big picture' for regulatory changes, the CASAC Final Report spells out the details for those changes. It contains 50 recommendations and with few exception,[85] they are applicable to OTC derivatives.

8.4 Proposed changes to regulators

The main thrust of the Wallis Final Report, which is of relevance to the OTC derivatives market, is the establishment of two main regulators - a prudential regulator and an investor/consumer protection regulator - to enable the financial system to be regulated functionally. Essentially, this calls for a re-arrangement of the functions of key regulators such as the RBA, the Australian Securities Commission (ASC), the ISC, the Australian Competition and Consumer Commission (ACCC) and the AFIC so that the responsibility for prudential regulation currently carried out by the prudential regulators are to be in the hands of a single regulator, referred to in the Wallis Final Report as the Australian Prudential Regulation Commission (APRC). Likewise, the investor protection functions of these agencies are to be repackaged and passed on to the ASC which is to be renamed the Corporations and Financial Services Commission or CFSC (now proposed by the Treasury to be known as the Australian Corporations and Financial Services Commission).

8.4.1 Australian Prudential Regulation Commission

Recognising the difficulties which the existing fragmented approach to prudential regulation presents, the Wallis Committee recommended that a single Commonwealth regulatory agency, the APRC, be established to carry out prudential regulation in the financial system.[86] This proposal has now received the Commonwealth Government's blessings, under a slightly altered name "the Australian Prudential Regulation Commission" (APRA).[87] It is proposed in the Wallis Final Report that the Commission will combine the existing prudential regulatory functions of the RBA, ISC[88] and AFIC[89] and bring all prudentially regulated financial institutions under the control of the Commonwealth.[90] The proposal will have the effect of replacing the

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[84] See section 148 of the *Australian Securities Commission Act 1989* (Cth).
[85] The Recommendations in the CASAC Final Report, note 1, which do not apply to OTC derivatives are Recommendations 9, 11, 32, 36, 41 and 49.
[86] Recommendation 31; Wallis Final Report, note 2, 316-317.
[87] Treasurer's Details accompanying his response to Wallis Committee, note 51, 4.
[88] Recommendations 38, 40 and 41, Wallis Final Report, note 1.
[89] Wallis Final Report, note 2, 316-317.
[90] Australian Institute of Banks and Finance, AIBF Stop-press, 'AIBF Member Update: Wallis Reports', Australian Institute of Banks and Finance, April 1997; see also Recommendations 31, Wallis Final Report, note 2.

prudential regulation of the AFIC in relation to State based financial institutions and bring building societies, friendly societies and credit unions under the umbrella of an agency of the Commonwealth.[91]

In relation to the intensity of regulation for different institutions, the APRC is expected to apply a calibrated system so that the methods employed may be commensurate with the risks in each group of institutions or with the products offered.[92] Regulation will be heaviest for banks and other deposit taking companies,[93] and less stringent for life and general insurance companies and trustees of superannuation funds.[94]

The Wallis recommendation has much merit. By vesting the prudential functions of all regulators in a single regulator, the disadvantages, discussed in Chapter 7 of this thesis, which are caused by a fragmented regulatory approach will be eliminated. Presumably, by bringing prudential regulation under one agency, there will be uniform treatment for products with the same characteristics and the anomaly resulting from application of different standards by different regulators will not arise under the proposed arrangement. It has been argued that the new regulator would be able to modulate its approach to regulation in the future as the market place continues to change.[95] There are, however, shortcomings in the Wallis approach and these are discussed below.

8.4.1.1 APRC and the perceived difficulties of the Wallis vision

While the recommendation for a single prudential regulator overcomes the problems caused by fragmentation in the regulatory structure,[96] the concept is not without difficulties. A major concern is the banking sector. In paragraph 7.2.1 of Chapter 7 of this thesis, mention was made of the fact that banks controlled over half of the total funds under management in Australia. The regulation of banks require specialist knowledge to provide effective regulation. Banks have very wide exposure to members of the public and will have public interest implications in the event of the failure of a bank. They take deposits from the public and in most cases promise to return the deposits at call. To make profits, they borrow short and then lend long, and in so doing they are susceptible to failure in the event of a run on the deposits of the banks. This is because banks are allowed to 'gear' against their shareholders funds and they thus do not have enough liquid cash to pay up their depositors all at once.

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[91] Recommendations 30, 35 & 36.
[92] Beerworth, B, 'A View From the Panel', The Australian Banker, Vol 111. No.3, June 1997, 92.
[93] Australian Institute of Banks and Finance, AIBF Stop-press, note 89.
[94] Beerworth, B, note 91, 92.
[95] Beerworth, B, note 91, 92.
[96] The difficulties of a fragmented regulatory structure was discussed in Chapter 7 of this thesis.

Because of the size of the funds they control and the devastating effect this would have on a large number of investors if a systemic crisis were to develop, banks merit every consideration to ensure that the risks to which they may be exposed are, as far as possible, neutralised.

The fear is that the removal of the RBA from its prudential role may reduce its ability to advert financial crisis and to manage that crisis once it is in progress.[97] It has been argued that prudential regulation provides a regulator with insight and the authority to use a more precise instrument to avoid a crisis.[98] Such an advantage may be removed by the new arrangement. The new regulator is not expected to have a balance sheet and consequently will not have funds to inject into the system in the event of a crisis.[99] By proposing to divest the RBA of its traditional function of prudential regulation, the Wallis Committee has moved into uncharted territory, although it has been argued that about half the world's banking systems in developed countries are supervised by agencies which are not the central banks.[100] Overseas experience notwithstanding, it is submitted that such a move needs careful study in view of the vulnerability of the banking system to contagion risks.

Two factors help to increase this risk. First, banks are closely interlinked through the payment system so that the failure of one bank is likely to affect other banks adversely. Second, the nature of their assets and liabilities (highlighted above) means that at any time, banks are not in a position to repay all their depositors. It is thus important that the regulator be conversant with the special problems confronting the banking system and that it has comprehensive corporate knowledge to deal with the risks so as to avoid a contagion crisis or if such a crisis were to develop, to move swiftly to contain the problem. This has serious investor protection implications because it is the investors who will ultimately stand to lose if banks were to collapse.

Apart from the difficulties outlined above with regards to banks, the proposed arrangement by Wallis does not recognise the need for counterparties (of regulated entities) to be subjected to prudential regulation. The implication which this has for investor protection is discussed in paragraph 8.3.2.

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[97] See Mitchell, A, 'Dangers of a super-watchdog', *The Australian Financial Review*, 31 May 1996, 18, in relation to the concerns raised by Dr Alan Greenspan in the United States.
[98] Mitchell, A, note 97, 18.
[99] Kelly, P, 'The Wallis Revolution', *The Weekend Australian*, 12-13 April, 1997, 22.
[100] Beerworth, B, note 91, 90.

8.4.1.2 A possible solution?

In view of the shortcomings in the Wallis recommendations, it is proposed as a possible solution, that the recommendation of the Wallis Committee in establishing a single national prudential regulator be adopted but with one important difference. It is that the RBA would assume that role of the universal prudential regulator whereas in the Wallis Committee's recommendation, the RBA is to give up its prudential regulatory role in respect of banks to APRC. This solution proposed here would overcome the primary concerns identified in paragraph 8.4.1.1 that the removal of prudential functions from the RBA could increase contagion risk. Prudential regulation is very much a core function of the RBA. It would appear to possess the expertise necessary for a national prudential regulator in providing prudential regulation not only for the banks but also for the other financial institutions, superannuation trustees and insurance companies.

A second alternative may be for a new derivatives regime to be enacted in the manner suggested in paragraph 8.3.4.1, that is, as part of the Corporations Law which would provide for, among other things, a single licensing regime to apply to all financial products (including all derivatives) and a single disclosure regime for the sale of products. It is expected that each prudential regulator would be required to set prudential standards for the institutions it regulates and that such standards would conform to the broad statutory guidelines on prudential standards set for each type of institutions. The statutory guidelines may, for instance, adopt a tiered or layered approach by specifying a set of minimum standards or benchmarks for each type of institutions and for each category of derivatives products.

Such an approach recognises the importance of minimising the costs of regulation without compromising the protection for investors where such protection is deemed necessary. Prudential regulators are then at liberty to determine the intensity of regulation but their discretion is fettered by the statutory guidelines which fixes the minimum standards. To ease the regulator's task, it is suggested that derivatives products be graded according to their risks and that the risks be factored into the calculation for capital adequacy requirement.

In that scenario, prudential regulation continues to be focussed on institutions as it is at present but with the relevant regulator acting within the parameters set by the enactment. Thus the RBA would remain the sole prudential regulator for banks, the ISC for insurance companies and superannuation trustees, and the AFIC for State based financial institutions such as the building and friendly societies. It is submitted

that such an arrangement will address the concern highlighted in paragraph 8.4.1.1 above that the removal of the RBA's prudential functions may hamper it in its efforts to prevent and to manage a financial crisis. The broad legislative guidelines and the benchmarks set by the new enactment will also effectively overcome limitations which are thought[101] to have been created by a structure that has multiple regulators each applying a separate set of regulations.

Another shortcoming in the current framework - inconsistency in point of sale disclosure requirements - may be conveniently rectified at the same time by such an enactment, as proposed in this thesis. All that is required is for the proposed legislation to dictate the disclosure standards for each category of financial products. Adopting, in part, the proposals in the Wallis Committee's recommendation no. 8,[102] it is suggested that the proposed enactment require mandatory disclosure by all sellers of OTC derivatives and other financial products in respect of such information as is prescribed by regulation (which will be made under the proposed enactment). The regulation could require comprehensive and sufficient disclosure on a detailed list of items, such as the credit rating of the product, the fees or commission charges by the dealers or advisers, expected rate of return and characteristics of the products,[103] with the aim of providing information that enables comparison between products. One way of achieving this is to require the completion of a pro-forma statement set out in the regulation. A standard disclosure policy applied across all OTC derivative products and other financial contracts will help to ensure uniformity and enable the investor to readily compare the merits of different investment products.[104]

8.4.2 Corporations and Financial Serviees Commission

The second key functional regulator proposed in the Wallis Final Report is the CFSC, renamed by the Commonwealth Government as the Australian Corporations and Financial Services Commission (ACFSC), which is to be established as a Commonwealth regulatory agency with three inter connected roles, namely, as the regulator for financial market integrity (covering both the retail and wholesale financial

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[101] Alan Cameron, the present Chairman of the ASC, has advanced the view that in a fragmented regulatory structure, "there are inevitably some limitations upon what can be achieved where there are two regulators and two sets of regulations." See Cameron, A, note 30, 97.

[102] The Wallis Committee's Recommendation no 8 differs from the suggested solution in that the Wallis Committee's vision relies on the CFSC monitoring disclosure requirements to ensure easy comparison of products while what is proposed in this thesis is that the standards of disclosure be dictated by regulation thus obviating the need to use a regulator to monitor consistency in disclosure standards.

[103] Wallis Final Report, note 2, 262.

[104] Non uniformity in approach by different regulators in respect of disclosure at the point of sale requirement was cited by Alan Cameron as a regulatory inconsistency in Cameron, A, note 30, 97. However, this problem would be fixed by the enactment of a new Act proposed in this thesis.

markets), the regulator for corporations and regulator for consumer protection.[105] This Commission is to be given powers (similar to those contained in consumer protection provisions in the TPA) to oversee the financial system.

This means that the CFSC will have sole responsibility for administering consumer protection[106] to the exclusion of the ACCC in relation to the financial sector. It also means that the TPA will not apply to the financial sector but instead, provisions comparable to those in the TPA will be included in the CFSC legislation.[107] The Commission is to be vested with broad enforcement powers - to impose administrative sanctions such as banning or disqualification orders, to initiate criminal prosecutions by referring criminal matters to the Director of Public Prosecutions and to initiate civil actions such as applying to a court for punitive financial penalties, restitution orders, injunctions and corrective advertising orders.[108]

The existing roles of the ASC, ISC, ACCC and the Australian Payments System Council (APSC) in maintaining market integrity and corporate and consumer protection are to be merged and the responsibility vested in the new Commission[109] which is in effect the ASC.[110] However, the ACCC's jurisdiction would not be withdrawn but shall have a limited role in continuing to be responsible for authorising financial exchange rules and arrangements under section 88 TPA.[111] The primary responsibility for administering and enforcing consumer protection laws for financial services rests with the CFSC.[112]

The CFSC's functions are to include:

- regulating disclosure for securities and retail investment products;
- regulating market conduct to promote orderly and efficient price discovery, trading and settlement;
- determining applications for new exchanges, and overseeing the activities of existing exchanges;
- regulating investment and insurance sales and advice and financial market dealers and participants;
- regulating conduct of dealings with consumers and the prevention of fraud;

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[105] Cameron, A, note 30, 96.
[106] Wallis Final Report, note 2, Recommendation 3; see also Kelly, P, note 99, 22.
[107] Wallis Final Report, note 2, Recommendation 3.
[108] Wallis Final Report, note 2, Recommendation 27.
[109] Wallis Final Report, note 2, Recommendation 1; Also see Treasurer's Details accompanying his response to Wallis Committee, note 51, 5.
[110] Treasurer's Details accompanying his response to Wallis Committee, note 51, 5.
[111] Wallis Final Report, note 2, Recommendation 5.
[112] Beerworth, B, note 92, 94.

- approving and overseeing industry codes of conduct and dispute resolution arrangements; and
- setting benchmarks for and monitoring the performance of those self-regulatory bodies.[113]

The Wallis Committee's recommendation pertaining to the role of CFSC will have a significant impact on the regulation of the OTC markets in the following areas:

1. <u>Licensing of intermediaries or dealer</u>

Under the Wallis Recommendation 13, the CFSC is to establish a single licensing regime for financial sales, advice and dealing and under Wallis Recommendation 23, the CFSC is to be empowered to license financial market intermediaries to operate an OTC market. These recommendations have been endorsed by CASAC[114] which holds the view that advisers and brokers of OTC derivatives transactions must have a financial markets licence. Under CASAC's proposals, there would be a single financial markets licensing system with different categories, including:

(a) acting as a broker in respect of OTC derivatives (Recommendation 20);
(b) market making or trading in the wholesale OTC derivatives market (Recommendation 21);
(c) trading as a principal in OTC derivatives products in the retail derivatives markets (Recommendation 22); and
(d) acting as an adviser in respect of OTC derivatives (Recommendation 24).

The recommendations by Wallis and CASAC support the contention in this thesis, stated in Chapter 4, that the OTC derivatives markets should be regulated[115] and that an important regulatory tool is licensing.[116]

2. <u>Authorising financial exchanges, including OTC markets</u>

In recognition of technological developments which makes it technically feasible for OTC (bilaterally negotiated) derivatives contracts to be cleared through a centralised system of exchange, it has been recommended that the CFSC be empowered to approve financial exchanges under a single authorisation procedure, with powers to attach conditions to the approval. It

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113 Recommendation 2. Wallis Final Report, note 2, 32.
114 CASAC Final Report, note 1, 122; see also recommendations 20 and 24.
115 See the arguments in paragraph 4.4.3 of Chapter 4 of this thesis.
116 See the concluding comments in paragraph 4.4.4.2 of this thesis

is expected that the conditions will depend on the nature of the market authorised, with formal exchanges being subjected to more detailed regulation than OTC markets because of the exchanges exposure to a greater number of participants.[117]

3. Removal of bar on retail participation of OTC derivatives markets

The current ASC Policy 70 restricts approvals for exempt markets to sophisticated participants, thus effectively denying retail investors the opportunity to participate in OTC derivatives markets and consequently protect them from potential losses. The Wallis Committee recommended that the prohibition on retail investors should be discontinued. It further proposed that an additional layer of consumer protection be provided for retail investors.[118] The Recommendation does not provide details as to how this is to be achieved. However, it is submitted that Recommendation 20 is sound and ought to be supported.

8.4.2.1 CFSC and the difficulties in the Wallis recommendation

Under the Wallis recommendation, the CFSC will not be the sole regulator for disclosure although it would be primarily responsible for point of sale disclosure standards.[119] This role is shared with the APRC which under Recommendation 44 is required to promote more transparent disclosure such as disclosure of indicators of the risk assumed by the entities which it regulates. To some extent, the regulatory overlap will create inefficiencies.

The more significant problem with the Wallis proposal is the weakening of the standard for investor protection. At present, the TPA does not provide for due diligence defence. The defence allows a seller to argue that reasonable precautions were taken to ensure the accuracy of information provided to consumers.[120] The Wallis Committee recommended that where a due diligence defence now applies to a positive disclosure requirement,[121] as under the prospectus or takeover provisions[122] it should have full effect notwithstanding section 995 of the Corporations Law and section 52 TPA. In making this recommendation, the Wallis Committee was clearly putting market efficiency objectives ahead of investor protection.

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[117] Wallis Final Report, note 2, Recommendation 21.
[118] Wallis Final Report, note 2, Recommendation 20.
[119] See Cameron, A, note 30, 98.
[120] Kelly, P, note 99, 22.
[121] Wallis Final Report, note 2, Recommendation 4.
[122] Cameron, A, note 30, 96.

A third problem which could arise is the issue of "regulatory capture". The recommendation that the financial sector be regulated by a specialist regulator namely, the CFSC exposes the regulator to the possibility that it may develop a shared interest with the regulated.[123] Therefore, in terms of its administration, the effect of the Wallis recommendation would be to water down investor protection firstly, because of the possibility of regulatory capture and secondly, because a new regulator which has no track record in protecting consumers interests is being given the sole mandate for such a role. Clearly there is greater merit in vesting the consumer protection function in the ACCC than in the ASC, as proposed by the Wallis Committee. The ACCC is an experienced regulator for consumer protection and the question of regulatory capture would not have arisen.

8.4.3 Conclusion on Wallis recommendations on regulators

The Wallis Final Report delivers advantages as well as disadvantages for investor protection. The concept of two national regulators, one to oversee prudential regulation and the other to supervise investor protection and a fair and orderly market will help to streamline the regulatory framework and provide a more cohesive structure. They also address many of the difficulties with the existing fragmented structure which has given rise to regulatory gaps. On the other hand, the proposals have brought fresh problems, the most significant of which is a weakening of investor protection, discussed in paragraphs 8.4.1.1 and 8.4.2.1. Apart from these new difficulties, the Wallis Final Report has not gone far enough in some areas where investor protection is needed. Prudential regulation remains focussed on banks, other financial institutions, insurance entities and superannuation funds. Taken as a whole, however, it is submitted that the advantages of the Wallis proposals outweighs the disadvantages and that with some judicious modifications, would be a definite improvement on the regulatory structure for financial derivatives.

8.5 Treasury's proposals for law reform

Just as this thesis was being finalised for binding, the Commonwealth Government released its policy paper, *Financial Markets and Investment Products*[124] (Position Paper), proving yet once again the fast pace of development in derivatives regulation. In view of its direct relevance to the subject matter of this thesis and on the advice of my primary supervisor, Professor Eugene Clark, this paragraph 8.5 has been included to provide the latest update on the direction in which derivatives regulation is moving.

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[123] Kelly, P, note 99, 22.

[124] Commonwealth of Australia, *Financial Markets and Investment Products*, Corporate Law Economic Reform Program Proposals for Reform: Paper No 6, AGPS, 1997 (Position Paper).

8.5.1 Outline of Position Paper

The Position Paper was foreshadowed by the Treasury in its Corporate Law Economic Reform Program.[125] As originally conceived, the Position Paper was intended to provide an "appropriate policy response to the growing importance of derivatives in financial markets."[126] It is the last of the six policy papers released by the Treasury on key areas of corporate law policy under this Program.

The aim of this paragraph 8.5 is therefore, to examine the key proposals in the Position Paper to determine the extent to which they have the capacity of providing the appropriate policy response by remedying the deficiencies which have been identified in the earlier Chapters of this thesis in relation to the regulatory structure. For convenience, these proposals have been included in Appendix 3 of this thesis.

The scope of the Position Paper is not confined to OTC derivatives nor indeed is it limited to purely securities and derivatives products. The Position Paper canvasses the idea of uniform regulation for a much wider range of financial instruments than those currently regulated by Chapters 7 and 8 of the Corporations Law. For the purpose of this Chapter, the discussion on the proposals in the Position Paper will be limited to derivatives and no attempt will be made to evaluate the impact which these proposals may have on other financial instruments.

If implemented, the proposals would establish a new regulatory regime for financial markets and investment products. The proposals are significant for not only do they show how rapidly regulation on financial derivatives and other capital market instruments is progressing, they also provide interesting concepts in regulation by moving away from black lettered law, which up to now, has been the approach adopted in securities and futures regulation.

The proposals are built partly on the recommendations of the Wallis Committee's *Financial System Inquiry, Final Report* (Wallis Final Report)[127] and are aimed at providing a more uniform regime for financial markets and products as well as financial intermediaries.[128] The proposed regime is intended to:

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[125] The Government's paper on the 'Corporate Law Economic Reform Program' (undated) was released around early January 1997, ahead of the Wallis Final Report.

[126] Treasury, 'Corporate Law Economic Reform Program', note 125, 4.

[127] Wallis Final Report, note 2. The recommendations in the Wallis Final Report which are dealt with in the Position Paper are Recommendations 8, 9, 13, 15, 19, 20, 21, 22, 23, 24 and 89. Additionally, Recommendations 1, 2, 5, 7, 14, 27, 29, 57, 58, 80, 109 are referred to in relation to the role and powers of the proposed Australian Corporations and Financial Services Commission (AFSC). These recommendations are reproduced in Appendix 3 of this thesis.

[128] Position Paper, note 124, 8.

(a) provide comparable regulation of all financial products, including securities, derivatives, superannuation, life and general insurance and bank-deposit products;

(b) provide a licensing regime for financial markets and provide consistent and comparable regulation for similar financial products;

(c) provide a licensing regime for financial intermediaries and impose harmonised statutory obligations designed to protect retail investors; and

(d) ensure that promoters or issuers of financial products provide comprehensive disclosure documents which assist investors to make informed decisions.[129]

Relevant proposals in the Position Paper will be discussed with reference to the findings of this thesis as set out in this Chapter.

8.5.2 Addressing the gaps in the Corporations Law

As seen in paragraph 8.2.1, a major finding of this thesis is the exclusion of the majority of derivatives contracts from the jurisdiction of the Corporations Law by reason of the definition of 'securities' and 'futures contracts'. Proposal No 1 in the Position Paper calls for uniform regulation of 'financial instruments'. A new regime will apply to securities, derivatives and other financial instruments. The term 'financial instruments' encompasses "all securities, futures and other derivatives, foreign exchange, superannuation, general and life insurance and deposit accounts."[130] By replacing the separate regimes for securities and futures contracts with a single regime for financial instruments, and by coining a new definition for 'derivatives', discussed below, the Treasury's proposals would have the potential to address the criticism that the current archaic definitions of 'securities' and 'futures contracts' do not catch some of the new generation of derivatives contracts and thereby create regulatory gaps.[131]

The proposed definition of 'derivatives' is a definition by inclusion and, as presented in Appendix C of the Position Paper, would include OTC derivatives contract. The definition would also appear to encompass the four species of futures contracts currently excluded by 72(1)(d) of the Corporations Law. This observation is based on the fact that paragraph 72(1)(d) has not been mirrored in the proposed definition of

[129] Position Paper, note 124, 10.
[130] Position Paper, note 124, 1.
[131] The difficulty with the current definitions was discussed in paragraphs 8.2.1 and 8.2.2.

derivatives.[132] Presumably, the preferential treatment given to banking products is to be abolished. If this is the intention, then such banking products would be brought within the purview of the Corporations Law and would no longer be unregulated products.

Two important implications arise from the proposed amendment to the definition of derivatives. First, it would have the effect of addressing most of the major gaps and deficiencies in the Corporations Law regime discussed in paragraph 8.2.1 and 8.2.2 above. In recognising the need for a new definition to cover 'derivatives', the Position Paper lends support to the findings in this thesis that gaps exist in the Corporations Law structure and also supports the recommendations made in this thesis.[133]

A second implication of the Treasury's proposal is that securities will be one of the several financial instruments and will be subject to the same regulatory regime as derivatives. It has been argued in paragraph 8.3.4.1 above that a single regime to regulate both securities and futures contracts will cause a regulatory misfit. For the reasons given in paragraph 8.3.4.1, securities and derivatives require separate regulatory treatment.

That derivatives are being traded on both the Australian Securities Exchange (ASX) and the Sydney Futures Exchange (SFE)[134] or that substantially similar products such as LEPOs[135] are traded on the ASX as securities and on the SFE as futures contracts have not changed the fundamental differences between securities and derivatives contracts, as the Treasury Position Paper seems to suggest. It is true that some financial instruments are hybrids and exhibit the characteristics of securities and futures contracts and that some derivatives give rise to a transfer of title to a physical asset (as securities do) if held to expiry.[136] However, these are in the minority and are the exceptions rather than the rule. To fashion a set of regulations based on the characteristics of the minority and apply it across the board would have the effect of

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[132] Position Paper, note 124, 134.

[133] The recommendations are that in relation to futures contracts, it be renamed 'derivatives contracts' and be redefined to include all derivatives instruments (Recommendation 4 of this thesis: see Chapter 9) and, in relation to paragraph 72(1)(d) of the Corporations Law, the preferential treatment currently given to banks be abolished or alternatively, paragraph 72(1)(d) be redrafted to take into consideration other classes of derivatives contracts deserving of exclusion and other institutions which are prudentially regulated (Recommendation 8 of this thesis: see Chapter 9).

[134] Position Paper, note 124, 36.

[135] This is the acronym for Low Exercise Price Options. A LEPO is in the form of a call option with a very low exercise price usually between one and ten cents and is exercisable only on the last day of trading before expiry. See Carew, E, *Derivatives Decoded*, Allen & Unwin, Sydney, 1995. 134.

[136] Position Paper, note 124, 36.

subjecting the majority of derivatives to a regime that would be inappropriate. Such regulation must, of necessity, be broad based and 'fuzzy'.

Fuzzy law has been claimed to provide several benefits, among which are that:

> "it would encourage our courts to move away from technicalities and towards substance. It would discourage loopholing, because without precise black-letter law, it would be harder. It would focus attention on what was right and wrong."[137]

While broad based regulation is arguably more flexible than prescriptive regulation, it can have serious implications for investors trading in the OTC derivatives markets. First, broad based laws may not be effective because of the danger that not being specific, the law could give rise to uncertainty and ambiguity. In penal statutes, it is a general rule that any ambiguity will be construed in favour of an alleged offender,[138] rendering the law less effective because of the difficulty of securing a conviction. This difficulty with enforcement could encourage a greater degree of market misconduct.

Second, the generality of fuzzy law will vest greater discretion on the regulator. Such a wide discretion might render a regulator more vulnerable to undesirable influence from the regulatees.[139] The dangers of regulatory capture has already been alluded to in paragraph 8.4.2.1.

Third, there is the danger that a broad brush technique to regulation will not focus on specific regulatory needs which are necessary to protect an investor. Some issues such as netting,[140] off balance sheet treatment of derivatives[141] and the high volatility of derivatives instruments need to be addressed in the context of investor protection but these issues are of little relevance to securities and some instruments within the

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[137] Green, J, '"Fuzzy Law" - A Better Way to Stop the Snouts in the Trough?', 9 *Company and Securities Law Journal,* 1991, 144 at 149 cited in Tomasic, R & Bottomley, S, *Directing the Top 500,* Allen & Unwin, Singapore, 1993, 167.

[138] This approach was adopted by the High Court in *R* v *Adams* (1935) 53 CLR 563 at 567-8 where the Court provided the following guidelines for interpretation of an enactment which is uncertain or ambiguous:

> "No doubt, in determining whether an offence has been created or enlarged, the Court must be guided ... by the fair meaning of the language of the enactment, but where that language is capable of more than one meaning, or is vague ... then it ought not to be construed as extending any penal category.".

[139] Tomasic, R & Bottomley, S, note 137, 185, citing Cranston, R, 'Regulation and Deregulation: general Issues' in Tomasic, R, (ed.), *Business Regulation in Australia,* CCH Australia, Sydney, 1984, 13 at 25.

[140] This was discussed in paragraph 5.5 of this thesis.

[141] This was discussed in paragraph 1.1 of this thesis.

proposed definition of "financial instruments". In providing a single regime for a variety of financial instruments with diverse functional characteristics, some of the current concerns on derivatives may not be considered.

Some of the recent proposals made by the Treasury have the potential to resolve some of these difficulties although it is submitted that the arrangements for effecting those proposals are unsatisfactory. In relation to netting, it was proposed in the Treasury's paper on "Electronic Commerce"[142] (Electronic Paper) released in late 1997, that the legislation recommended by CASAC for the recognition of close-out and market netting arrangements be adopted.[143] It is disconcerting that the Position Paper itself has not made any reference to the issue of netting, despite it being a topic of significance for financial markets and investment products.

In relation to the concern that the broad criteria proposed in the Position Paper may be inadequate to effectively regulate some instruments, the Treasury has suggested that:

> "Where there is a clear need for different rules for particular markets or financial instruments, or a need to provide greater guidance about how to satisfy the legislative criteria, it is proposed that the detail may set be set out in:
>
> - regulations;
> - conditions imposed on a financial intermediary's licence;
> - industry codes adopted by the regulator; and
> - the rules developed by the market operator..."[144]

This solution is unsatisfactory as it could give rise to difficulties. The proposal would have the potential to create many separate regimes by detailed regulation to cater for the different regulatory needs of each financial product. This could increase complexity in the administration of the new regime.

Also the new concept of regulation for the financial markets, namely a fuzzy law regime supported by a patchwork of regulation and other stand-alone legislation to address the deficiencies in such a regime, would not appear to be user friendly as one is required to examine both the main legislation and the regulation made thereunder as

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[142] Commonwealth of Australia, *Electronic Commerce*, Corporate Law Economic Reform Program Proposals for Reform: Paper No 5, AGPS, 1997 (Electronic Paper).

[143] Electronic Paper, note 142, Proposal No 5. It was also a recommendation of the Wallis Committee that the legislative program should expedite preparation and consideration of netting legislation to cover failure to settle by participants in the payment system and legislation to give legal certainty to bilateral netting of financial transactions: See Wallis Final Report, note 2, Recommendation 59, reproduced in Appendix 3 of this thesis.

[144] Position Paper, note 124, 43.

well as other legislation such as the proposed Close-Out and Market Netting Act, the codes adopted by the regulator and codes of the market operator to determine what the applicable law or rules are on a particular instrument.

8.5.3 Addressing the gaps in the sanctions regime of the Corporations Law

It was seen in paragraph 8.2.3 of this thesis that gaps exist in the sanctions regime in Chapters 7 and 8 of the Corporations Law. Some offences provisions in the sanctions regime in Chapter 8 of the Corporations Law are not mirrored in the sanctions regime in Chapter 7 of the Corporations Law and vice versa even though those provisions are equally applicable to securities or futures contracts, as the case may be.

To recapitulate, hawking[145] applies only to securities and not to futures contracts or other forms of OTC derivatives contracts. On the other hand, there is no provision in Chapter 7 of the Corporations Law which is equivalent to section 1264 which prohibits fraud by a broker on its clients nor is there a provision in Chapter 7 which is equivalent to section 1258 of the Corporations Law. Section 1258 requires that dealings by futures broker on behalf of others to be made on-exchange or on an exempt market.

Proposal 8 of the Position Paper suggested that:

> "(t)he market misconduct provisions of the Corporations Law, which include insider trading and market manipulation will be harmonised for all markets where financial instruments are regularly traded by multiple buyers and sellers.
>
> Rules relating to misconduct by financial advisers and dealers, including breaches of licence conditions, will be harmonised and enforced by the ACFSC."

The Treasury, in its Position Paper, proposed to harmonise the sanctions regime for all markets trading in financial instruments, which includes securities and derivatives, by basing it on the securities provisions.[146] The rationale for preferring the securities regime over the futures market regimes is that although the market misconduct provisions for securities and futures contracts are somewhat similar and are intended to achieve the same regulatory objectives,

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[145] Section 1078 of the Corporations Law.
[146] Position Paper, note 124, 114.

"(t)he securities insider trading provisions were updated in 1991 as part of a general securities reform process. However, the futures insider trading provisions were not amended."

If the proposal for harmonisation means the adoption, in its entirety, of the sanctions regime in Chapter 7 of the Corporations Law in preference to those in Chapter 8, it is submitted that the gaps in the sanctions regime concerning the prohibition of frontrunning and bucketing will not be addressed. As pointed out in paragraph 8.2.4 of this Chapter, the Chapter 7 sanctions regime does not include provisions which are equivalent to sections 1258 and 1264 in Chapter 8 of the Corporations Law. These provisions serve an important purpose in that they proscribe some undesirable common market practices and their inclusion in the sanctions regime will assist in maintaining investor confidence in the Australian capital markets. However, it may be too early at this stage to come to a conclusive view as to whether gaps will continue to exist in the new regulatory structure proposed in the Position Paper. Much will depend on the provisions as they eventually appear in the legislation.

8.5.4 Addressing the gaps in the supervisory structure

In paragraph 8.3.2 of this Chapter, the point was made that the Wallis Committee, in recommending the establishment of a national regulator, the Australian Prudential Regulation Commission (APRC) to oversee prudential regulation, has not gone far enough to fill the gaps in the supervisory structure. Prudential regulation remains focussed on banks, other financial institutions, insurance entities and superannuation funds and no attempt is made to bring public listed companies under the supervision of a prudential regulator.[147] Even in relation to financial market licence holders, who can be expected to deal extensively with investors, the Wallis Committee has expressed the view, in Recommendation 18, that it is not necessary at this time to impose additional prudential regulation, capital or risk management requirements on financial market licence holders aimed at minimising contagion or systemic risk in the event of failure. However, the Wallis Committee recommended that this situation should be kept under review by the CFSC[148] in conjunction with the APRC.[149]

The Treasury's proposal in the Position Paper goes further than the Wallis Committee in offering investor protection. The Treasury recognises that the removal of restriction on retail participation in the OTC derivatives markets may result in the emergence of

[147] Paragraph 8.3.2 of this thesis.
[148] Now referred to by the Treasury as ACFSC.
[149] Now referred to by the Treasury as Australian Prudential Regulation Authority (APRA). See Glossary in Appendix 2.

new firms specialising in certain derivatives contracts to the retail sector and that some of these new firms may not be subject to the supervision of the APRA.[150] This is because APRA will provide prudential regulation only for deposit taking institutions, insurance companies and superannuation funds.[151] The absence of supervision of these firms could potentially result in considerable loss to retail investors who trade in OTC derivatives transactions. Accordingly, it recommended that financial intermediaries be required to demonstrate that they have appropriate capital resources and risk management systems consistent with international best practice.[152]

It is clear from the proposals in the Position Paper that the Treasury has adopted the strategy of regulating financial intermediaries as a means of delivering investor protection. A single licensing regime is to be introduced for financial market dealers and advisers.[153] Such a strategy was advocated earlier by Wallis Committee[154] and the Companies and Securities Advisory Committee (CASAC), in its report, 'Regulation of On-exchange and OTC Derivatives Markets, Final Report'.[155] In addition to prudential regulation, the Treasury has proposed that intermediaries be subject to the following statutory obligations:

- risk disclosure;
- confirmation documentation and periodic statements;
- accounts and record keeping;
- benefits disclosure;
- pressure sales;
- the suitability of personal product recommendations; and
- complaints and dispute resolution.[156]

In the main, the Treasury endorsed the recommendations of the Wallis Committee and the Companies and Securities Advisory Committee (CASAC), on risk disclosures,[157] benefits disclosure,[158] the suitability of personal product recommendations,[159] and complaints and dispute resolution.[160]

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[150] Position Paper, note 124, 95.
[151] Position Paper, note 124, 10.
[152] Position Paper, note 124, 95-96.
[153] Position Paper, note 124, Proposal No. 5.
[154] Wallis Final Report, note 2, Recommendation 13.
[155] CASAC Final Report, note 1, Recommendation 13.
[156] Position Paper, note 1, Proposal No. 6.
[157] CASAC Final Report, note 1, Recommendation 29; Wallis Final Report, note 2, Recommendation 8.
[158] CASAC Final Report, note 1, Recommendation 33.
[159] CASAC Final Report, note 1, Recommendations 31, 41.
[160] Wallis Final Report, note 2, Recommendation 25.

Whilst the Treasury's proposals are expected to improve investor protection for those who deal with financial intermediaries, they will not eliminate the gaps in the supervisory structure. No proposals have been made to impose prudential standards on public listed companies. By this omission, hundreds of thousands of shareholders in these companies are denied the statutory safeguards which could help to minimise the risk of their companies becoming insolvent due to imprudent derivatives trading. Consequently, equity investors remain unprotected under the proposed law reform.

Curiously, the national prudential regulator, Australian Prudential Regulation Authority (APRA)[161] merited only brief mentions[162] in the Position Paper despite the prominent role envisaged for it in the Wallis Final Report. The brevity of the discussion in the Position Paper makes it unclear, at this stage, as to its precise role and functions. The position is expected to crystallise once legislation is presented in bill form.

Part 12 of the Position Paper, which is devoted to a discussion of the new framework for the regulation of the financial system, focuses primarily on the regulatory responsibility of the Australian Corporations and Financial Services Commission (ACFSC).[163] However, it is uncertain as to whether the due diligence defence, recommended by the Wallis Committee,[164] would be adopted as this issue has not been raised in the Position Paper. If the Wallis recommendation stands, the criticism made in this thesis that the availability of the defence would water down investor protection remains.[165]

8.5.5 Conclusion on Position Paper

To summarise, the proposals in the Position Paper, if implemented will have the potential to fill some, but not all, of the regulatory gaps identified in this thesis in relation to investor protection.

As regards the gaps in Chapters 7 and 8 of the Corporations Law, on the assumption that paragraph 72(1)(d) of the Corporations Law will be abolished, and that derivatives will be defined to encompass OTC derivatives and derivatives over securities, as proposed in Appendix C of the Position Paper, most if not all derivatives

161 See Glossary in Appendix 2.
162 Position Paper, note 124, at 10, 82, 95, 117 and 120.
163 See Glossary in Appendix 2.
164 Recommendation 4.
165 See paragraph 8.4.2.1 of this thesis.

products will be regulated. In other words, the gaps in Chapters 7 and 8 of the Corporations Law will be filled to a large extent.

The extension of the jurisdictional boundaries of the existing securities and futures contracts regime to cover a variety of other financial instruments, raises serious concerns as the provisions of such a regime may undermine the effectiveness of regulation. Ineffective regulation often lead to market instability as it could increase the level of market misconduct. The enforcement difficulties could act as an incentive and result in greater readiness by perpetrators to indulge in their illicit activities.[166]

Also, it is difficult to see how a fuzzy law regime supported by a patchwork of regulation and other stand-alone legislation to address the deficiencies in such a regime will be an improvement over the current regulatory framework.

In respect of the gaps in the sanctions regime governing derivatives, the examination of Proposal No 8 gives rise to the conclusion that these gaps will remain. The inadequacies in the sanctions regime of Chapter 7 of the Corporations Law which have been identified in Chapter 5 of this thesis, will be carried over to the new sanctions regime for financial instruments unless provisions equivalent to sections 1258 and 1264 of the Corporations Law are included.

Lastly, the Position Paper does not appear to remedy the gaps in the supervisory framework. It has not been proposed in the Wallis Final Report, CASAC Final Report or the Position Paper that public listed companies, in which hundreds of thousands of investors are small shareholders, are to be subject to prudential regulation.

The above conclusions on the proposals in the Position Paper are merely tentative as it is uncertain what form the final legislation will take. Being a policy paper, the Position Paper contains only broad proposals and does not provide comprehensive discussion on any of them. For example, a number of recommendations in the Wallis Final Report and CASAC Final Report, which although relevant to the regulation of

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[166] Enforcement difficulties may arise from a number of factors, mainly because the success of fuzzy law:

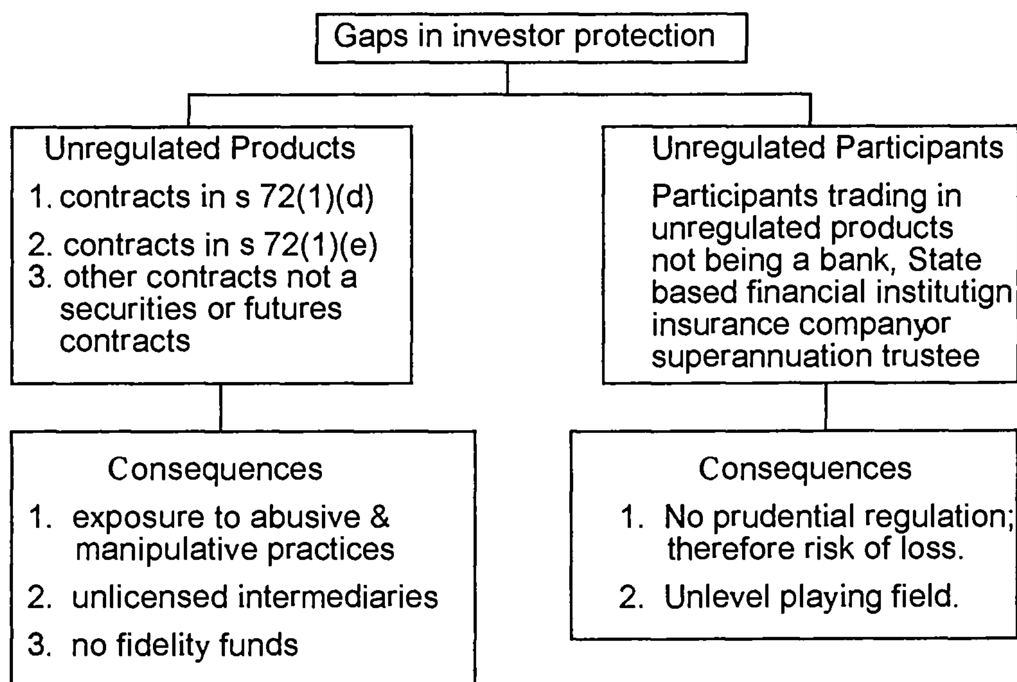
> "is dependent upon the preparedness of the courts to take note of the spirit of the law in a particular area. However, 'fuzzy law' is an inadequate device when courts are not prepared to do this and instead adopt a narrow legalistic approach to interpretation, ...Another difficulty is that ... a resort to general principles cannot occur in isolation and needs to be accompanied by appropriate judicial attitudes and improved mechanisms for access to courts" See Tomasic, R & Bottomley, S, note 14, 168.

derivatives, have not been referred to in the Position Paper.[167] One example is APRA, one of the two national regulators proposed by Wallis but was hardly discussed.[168] This creates uncertainty as to whether those recommendations will be adopted or rejected or modified in the proposed legislation. For that reason, the comments on the proposals may be considered as merely preliminary, pending more detailed and concrete proposals from the Treasury.

8.6 Conclusion

This Chapter has set out the more significant findings of this thesis. In essence, the primary finding is that gaps exist in the Corporations Law and that the majority of all derivatives fall within those gaps. Although the investor protection provisions under the TPA and the Crimes Act assist in closing some gaps, a good proportion of the gaps remain. These remaining gaps are also not filled by the prudential regulation of agencies whose jurisdiction to supervise are limited to banks, State-based financial institutions, superannuation trustees and insurance companies. The major findings and their implications are presented in a summary form in the figure below.

Figure 6



[167] The Wallis Final Report, note 2, contains a total of 115 recommendations while the CASAC Final Report, note 1, contains 50. Of these recommendations, only the following appeared to have been considered: CASAC Recommendations 2, 9, 10, 13, 21 (see Position Paper, note 1, 59) and Wallis Recommendations 1, 2, 5, 7, 8, 9, 13. 14. 15. 19, 20, 21, 22, 23, 24, 27, 29, 57, 58, 80, 89 and 109 (see Position Paper, note 124, 8-9).

[168] Wallis Final Report, note 2, Recommendations 31, 32, 33, 34, 36, 37, 39 40, 41, 42, 43, 44, 45, 48, 49, 50, and 51 concern APRA. Most of these recommendations were not discussed in the Position Paper, note 124.

So far there have been two attempts to accommodate financial derivatives. These regulatory initiatives were relatively minor and have little impact on filling the gaps.

The first was Policy Statement 70, referred to above, which was issued by the Australian Securities Commission. It offers an interim safe harbour to sophisticated participants and to members of a corporate group who trade among themselves. The strategy adopted was to grant exempt market status to sophisticated participants only. This effectively prevents retail investors from being market makers in the derivatives market.

The second regulatory incursion was through the *Corporations Law (Securities and Futures) Amendment Act 1995*, commonly called the "Share Ratio Act". This Act introduced two new provisions, sections 72A and 92A, into the Corporations Law. The effect of these two sections is to expand the scope of Chapters 7 and 8 to cover more groups of derivatives. The new provisions enable the ASC to prescribe a new contract as securities or as futures contract by way of Corporations Regulations, regardless of their true legal characteristics.[169] However, sections 72A and 92A are confined to exchange traded derivatives and have no application to OTC derivatives.

The inadequacy of regulatory initiatives to date and the findings of gaps and deficiencies in the regulatory framework have demonstrated a need for changes to be made to the current regulatory regime. The review of the recent recommendations and proposals of the Wallis Committee, CASAC and the Treasury in this Chapter give rise to the conclusion that they may not adequately address the gaps and deficiencies in the current regulatory structure. Added to these concerns are the difficulties which the proposals in the Position Paper, if implemented, could create. The new concept of fuzzy law proposed in the Treasury's Position Paper is revolutionary and a radical departure from the traditional approach. Such a shift may be unjustified as, being an untried concept in relation to commercial law (arguably is one of the most complex in its requirement for regulation), its success and the benefits it could deliver, particularly in the area of investor protection, is uncertain. As has been argued throughout this thesis, an evolutionary rather than a revolutionary approach would be the better strategy in managing the challenges as a consequence of recent developments in the capital markets. Adopting a cautious approach will ensure that Australia is not too far ahead of other countries.

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169 Donnan, F, 'The Share Ratio Act: Innovation or Experimentation in Securities Regulation?', *Companies and Securities Law Journal*, Vol 14, 1996, 101, at 102.

The final Chapter draws together the major themes developed in this thesis and suggests recommendations for law reform in the area of investor protection.

Chapter 8

CHAPTER 9

CONCLUSION

9.1 Introduction

This thesis sets out to analyse the gaps in existing legislation which would have an effect on investor protection and to suggest possible reform. The main findings were summarised in the previous chapter and their implications discussed. As noted in Chapter 8 of this thesis, some of the findings find support in the final report of the Wallis Committee[1] (Wallis Final Report), in the Companies & Securities Advisory Committee's (CASAC) reports including the recent 'Regulation of On-exchange and OTC Derivatives Markets, Final Report' (CASAC Final Report)[2] and in the Treasury's paper on 'Financial Markets and Investment Products' (Position Paper).[3]

The findings in this thesis demonstrate that the regulatory framework, as it stands, is unsuited to delivering adequate protection for investors trading in the OTC derivatives markets. This conclusion is made on the basis of the analysis carried out in this work which shows that gaps exist in the regulatory structure resulting in the majority of derivatives products traded in this country being unregulated by the Corporations Law and the majority of public listed companies being unregulated participants, that is, unsupervised by any regulatory agency. It has also been demonstrated that these gaps increase financial risks for investors.

Having discussed the major findings and the implications of those findings in the previous Chapter, this Chapter re-visits the research questions identified in Chapter 1 and makes recommendations for law reform. As the issues raised by those questions have largely been covered elsewhere in this thesis, it is proposed that responses to each of these questions be set out briefly.

9.2 Research questions

9.2.1 Whether adequate regulatory measures exist to deal with the risks inherent in derivatives trading, including market risks, credit risks and legal risks

This question has been framed to assess the capacity of the current regulatory framework to control risks associated with derivatives trading. This is an

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[1] This refers to the Financial System Inquiry, *Financial System Inquiry Final Report*, Australian Government Publishing Service, March 1997 (Wallis Final Report).

[2] Companies & Securities Advisory Committee, 'Regulation of On-exchange and OTC Derivatives Markets, Final Report', June 1997 (CASAC Final Report),

[3] Commonwealth of Australia, *Financial Markets and Investment Products*, Corporate Law Economic Reform Program Proposals for Reform: Paper No 6, AGPS, 1997 (Position Paper).

important issue since the existence of risks has the potential to expose investors to losses and the ability of the regulatory structure to manage risks is a hallmark of investor protection.

The analysis of the regulatory framework in this thesis has identified two varieties of deficiencies in the Corporations Law which increase risks for investors: These risks arise because of deficiencies in some definitions and provisions in the Corporations Law which, as they have not been tailored for derivatives, are unsuitable for their regulation. They also arise because of the deficiency of the Corporations Law in failing to include provisions which would help to reduce risks.

How these deficiencies increase market, credit and legal risks to investors have been discussed in paragraph 8.3.3 of the previous Chapter. Gaps in the regulation provide opportunities for unscrupulous participants in the OTC markets to carry out manipulative, deceptive or unfair practices which could distort market prices of the derivatives instruments and consequently increase market risks. As regards credit risks, these are increased because of the failure of the Corporations Law to clarify the law in relation to netting. For example, under section 588FA of the Corporations Law, a netting arrangement could be deemed to be an unfair preference and therefore unenforceable. As netting contracts are important tools employed by investors to reduce their exposure to credit risk, the failure of the Corporations Law to clearly and unambiguously uphold netting arrangements has resulted in a higher credit risk than necessary. Similarly, deficiencies in the Corporations Law create legal risks, criminal and civil. The outdated definition of futures market and the wide interpretation given to this term by the courts could cause an investor to unintentionally contravene section 1123 of the Corporations Law by trading in an unauthorised futures market. A second source of legal risk arises from the unenforceability of derivatives contracts due to a variety of reasons including the operation of the ultra vires doctrine, insolvency laws or crown immunity.

It is plain from the discussion of risks both in Chapter 3 and in Chapter 8 of this thesis that the regulatory measures in the Corporations Law are inadequate to deal with the risks inherent in derivatives trading and that this shortcoming has an adverse impact on investor protection.

9.2.2 Does the regulatory regime adequately address unfair practices and other misconduct?

This question is essential to an assessment of the regulatory framework's ability to protect investors in the OTC derivatives market. In the absence of statutory protection against undesirable market practice, perpetrators could stand to reap unjust profits by exploiting investors who are less capable of protecting themselves. In consequence, investors could suffer a loss simply because there is no mechanism in place to protect them against abusive market practices.

The Corporations Law regime has a range of sanctions to control unfair practices and market misconduct but its reach is limited to those OTC derivatives which are within the legal definition of "securities" and "futures contracts". In relation to OTC derivatives transactions unregulated by the Corporations Law, the analysis in Chapter 6 of this thesis shows that neither the Corporations Law nor the combination of the general criminal and consumer laws adequately address the issue of unfair practices and market misconduct. This work has established that such undesirable conduct as hawking,[4] bucketing,[5] frontrunning,[6] and arguably such market offences as insider trading and the dissemination of information about impending illegal market activities, may be carried out with impunity by unscrupulous market participants in the OTC derivatives markets since the conduct does not appear to be an offence in Australia.

It is to be concluded that the regulatory regime does not adequately address unfair practices and other misconduct, principally because the sanctions regime does not apply to the majority of the OTC derivatives contracts.[7] As

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[4] Hawking is an offence only for securities transactions and this conduct is not proscribed in respect of all other derivatives transactions. See Table 4 of this thesis.

[5] Bucketing is an offence under the Corporations Law only if the transaction is a "futures contract". It is not an offence if it is carried out in respect of transactions which are securities or derivatives contracts which are not "futures contracts". See Figure 4 in Chapter 6 of this thesis.

[6] Frontrunning is an offence under the Corporations Law only in respect of futures contracts and on exchange securities. The sanctions regime does not apply to securities or other derivatives contracts; See Figure 4 and paragraph 6.2.2 of this thesis.

[7] See Wallis Final Report, note 1, 367, Table 9.1, citing as its source, the Australian Financial Markets Association 1996 Australian Market Report. Table 9.1 shows that the OTC financial markets account for AUD 20,269 billion out of a total of AUD 27,051 billion. Most of the OTC contracts are traded with a bank as a counterparty and of the OTC contracts, it is expected that bank trading accounts for the bulk of all OTC contracts. Section 72(1)(d) of the Corporations Law exclude currency swap, interest rate swap, forward exchange rate contracts and forward interest rate contracts to which a bank is a party, from the definition of futures contract. Such contracts are unregulated by the Corporations Law.

mentioned earlier, unless a derivatives contract is within the definition of 'securities' in section 92 of the Corporations Law or a 'futures contract' within section 72, it will not be regulated by the sanctions regime in Chapters 7 or 8 of the Law. If integrity, fairness and efficiency of the OTC derivatives markets (and, consequently, investor protection), are to be maintained, there should be an effective sanctions regime against undesirable practices.[8] This requires that the regulatory gaps in the Corporations Law identified in Chapter 5 of this thesis be filled by ensuring that all derivatives contracts be regulated under the Law. However, the regulator should be vested with a discretion to exempt derivatives contracts in appropriate cases.

9.2.3 Should all intermediaries be licensed so as to ensure proper oversight of their activities by a regulatory agency?

It has been argued in Chapter 4 of this thesis that for the reasons stated therein, licensing is important for the protection of investors in the OTC derivatives market.[9] Licensing is an effective means of controlling the conduct of intermediaries. It sets entry standards thus ensuring that intermediaries meet minimum requirements for competence, integrity and financial soundness.[10] Additionally, it regulates the conduct of brokers towards their client investors, and it is an important regulatory tool which provides the regulator with a measure of control through the imposition of conditions on licences and disciplinary actions.[11]

At present, there is no licensing requirements for the OTC derivatives markets,[12] and as Figure 4 of this thesis shows, there are no laws to proscribe fraudulent practices by brokers against their clients.[13] Investors in the OTC markets are therefore vulnerable to exploitative practices by intermediaries such as frontrunning or bucketing since there are no effective means of controlling the conduct of intermediaries towards their clients. The answer to this question is therefore in the affirmative.

The view that intermediaries ought to be licensed is supported by CASAC which, in recommendations 20 and 21 of the CASAC Final Report, advocated that persons should be prohibited from carrying on a business of broking or

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[8] See paragraph 4.3.4.4 of this thesis.
[9] See paragraph 4.3.4.2 of this thesis.
[10] CASAC Final Report, note 2, 105.
[11] CASAC Final Report, note 2, 105.
[12] CASAC Final Report, note 2, 114.
[13] The analysis in this thesis indicates that criminal and consumer laws do not apply to conduct by intermediaries known as frontrunning or bucketing. See Chapter 6 of this thesis.

market making (to wholesale end-users) unless they are licensed. The view is also held by Wallis Committee which, in recommendation 13 of the Wallis Final Report, suggested that there be a single licensing regime to control investment advice and product sales, general insurance brokers, financial market dealers and financial market participants.

9.2.4 Should derivatives traders be required to observe capital adequacy and other prudential requirements?

Under the current regulatory framework, prudential regulation has not been applied to all derivatives participants but only to banks, insurance companies, superannuation funds and state based financial institutions.[14] In the broad sense, prudential regulation is concerned with financial safety of an entity. Financial safety for derivatives may be improved through capital adequacy requirements, limiting derivatives transactions to a prudent amount and through risk management systems.[15]

Capital adequacy is an important strategy which helps an entity to withstand financial adversity. In volatile markets, adequate capitalisation will increase a trader's ability to absorb financial shocks and improve its chances of survival. Not only will imposition of capital adequacy standards protect equity investors and other stakeholders in the derivatives trader, it can also be a measure of the credit risk which such a trader poses to its counterparty in a derivatives transaction. Obviously, the better capitalised the trader is, the less likely is it to fail or default.

As pointed out in paragraph 4.4.4.3 of this thesis, prudential regulation enhances investor protection. It has been argued in paragraph 8.3.2 of the previous Chapter that such regulation should be applied to all[16] derivatives participants (ie, all entities dealing with retail investors trading in the derivatives markets and to wholesale as well as end-users which are public listed companies). These derivatives traders should be required to observe capital adequacy and other prudential requirements, including the provision of an adequate risk management system, although perhaps with varying intensity of regulation.

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[14] See Chapter 7 of this thesis.
[15] CASAC Final Report, note 2, 129.
[16] But excluding exempt derivatives participants. Also, it is not expected that participants be subject to more than one set of prudential regulation. Banks, which are presently regulated by the Reserve Bank of Australia, should not be required to be prudentially regulated under the Corporations Law.

The view in this thesis that derivatives traders should be required to observe capital adequacy and other prudential requirements is shared by CASAC. In the CASAC Final Report, it considered 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."[17]

This issue was not considered in the Wallis Final Report.[18]

9.2.5 Whether OTC derivatives traders have adequate investor protection under the Corporations Law

This work has shown that many of the OTC derivatives traders[19] are not entitled to the statutory safeguards under the Corporations Law.[20] This is because excluded contracts within paragraph 72(1)(d) of the Corporations Law account for about two thirds of the total derivatives market in Australia.[21] The majority of OTC derivatives are therefore largely unregulated by the Corporations Law. It has also been established that the majority of public listed companies (which are potential derivatives participants) are not subject to any prudential regulation. The implications of unregulated products and unregulated entities in relation to investor protection have been discussed in Chapter 8 of this thesis.

Further, it needs to be borne in mind that the participants trading in the OTC market carry more risks than on-exchange markets.[22] Briefly, these risks include the greater complexity of OTC instruments, generally higher values per contract, a longer executory period for each contract and illiquidity, in the

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[17] CASAC Final Report, note 2, 137.

[18] The closest which the Wallis Committee came to an expression of views was in recommendation 18. All that it said was merely that it was not necessary at this time to impose capital or risk management requirements on financial market licence holders. Licence holders are a smaller group than the derivatives traders.

[19] See Chapter 5 of this thesis, and in particular, paragraph 5.7.

[20] See Chapter 5 of this thesis, and in particular, paragraph 5.6.3.

[21] Reserve Bank of Australia, 'Survey of Derivatives Market Activity in Australia', Media Release No 95-21, 19 December 1995 Table 1. The calculation is made from the figures as at end March 1995 provided in Table 1.

[22] See paragraph 4.4 of this thesis.

sense that there is no ready facility for closing out an OTC contract, except by agreement between the two parties to it.

Clearly, the existing regulatory structure does not provide adequate investor protection for OTC derivatives participants.

9.3 Inadequacy of current regulatory structure

The above questions and the responses to them have assisted in putting into context the appropriateness of the current regulatory regime. A clear inference which may be drawn from this work is that the current regulation is insufficient to offer OTC investors effective protection. The deficiency in investor protection stems mainly from the lacunae in the Corporations Law. The problems in relation to OTC derivatives are created by a regulatory structure built on foundations which are inappropriate to derivatives. Chapter 7 of the Corporations Law, governing securities, was not originally intended to be a part of the regime for these new capital instruments but perforce was included in the absence of more specific legislation. Similarly Chapter 8 was at its inception intended for the regulation of futures contracts,[23] which represents but one class of derivatives. It was not designed to accommodate financial derivatives. The regimes in both Chapters 7 and 8 pre-dates the advent of financial derivatives (in the forms in which they appear today) and except for the implementation of Policy Statement 70 in 1993 and the introduction of the *Corporations Law (Securities and Futures) Amendment Act 1995* - no attempt has been made to modernise the Corporations Law.

The inappropriateness of using Chapters 7 and 8 for regulating financial derivatives has manifested itself in gaps in regulation, with some OTC derivatives unregulated by the Corporations Law. This has not been helped by the failure of criminal and consumer laws to provide a viable alternative (to the sanctions regime in the Corporations Law) so that undesirable market practices could be discouraged. In Chapter 6 of this thesis, it has been demonstrated that general consumer and criminal laws, although helpful in conduct such as fraud, misleading or deceptive conduct, have no capacity to fill up the remaining gaps in the Corporations Law. Unregulated participants who trade in unregulated products do so in an environment which is virtually free[24] from any intrusive government interference of any kind. The

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[23] However, it is acknowledged that the definition of futures contracts catches more than one of the four traditional categories of derivatives products, namely forwards, futures, swaps and options. Nevertheless, it does not cover many others which do not fall within section 72 of the Corporations Law..

[24] The general laws under the TPA and Crimes Act still apply but as seen in Chapter 6 of this thesis, market based offences such as insider trading, hawking and frontrunning are arguably totally

difficulties with derivatives regulation are further compounded by the fragmented approach to institutional regulation. The analysis of the supervisory structure has shown that the current patchwork of regulation has left some institutions without prudential supervision.

9.4 To regulate or not to regulate?

A central policy issue which needs to be addressed is whether further regulation is appropriate or whether the existing structure, defective though it is, can adequately oversee the OTC derivatives markets.

One of the most powerful arguments against further government regulation is the issue of costs and its associated disadvantages. Given that costs is involved in compliance with any regulation, it has been contended that unnecessary regulation stunts growth and that, for example, the competitiveness of the exchanges in the United States in the volume of derivatives trading is directly affected by the regulatory constraints placed on them.[25]

A view which has been canvassed occasionally in support of the proposition against regulation is that the market is itself a very powerful regulator of economic activities[26] such as derivatives trading. Consequently, it has been argued, no government regulation or even self regulatory organisation is necessary as derivatives participants have behaved in a responsible manner so far.[27]

Thirdly, it has been suggested that OTC derivatives do not create new risks[28] for participants using them and that such risks as are associated with derivatives are common to other financial transactions. A related argument against regulation is the possibility of international regulatory arbitrage. The globalisation of the derivatives markets[29] provides opportunities for an Australian participant to buy or sell derivatives contracts in any financial centre in the world. Conceivably, derivatives transactions could be driven off-shore if Australian regulations are more onerous than the regulations prevailing in other countries. The history of Eurodollars may be used

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unregulated.

[25] Leon, R, 'The Regulation of Derivatives and the Effect of the Futures Trading Practices Act of 1992', *Journal of Law and Policy*, Vol 3, 1994, 321.

[26] Culp, CL, & Mackay, RJ, 'Regulating Derivatives: The Current System and Proposed Changes', CATO Regulation, *The Review of Business & Government* (undated), 15. http://www.cato.org/pubs/regulation/reg17n4b.html

[27] Culp, CL, & Mackay, RJ, note 26.

[28] See for example, Culp, CL, & Mackay, RJ, note 26.

[29] See Wallis Final Report, note 1, 21.

to illustrate this point.[30] The United States Government had sought to limit the use of Eurodollar deposits by domestic companies by means of various legislation. Its intention was to regulate the effects of dollars deposited outside the United States but since the deposits were outside the country, they were not subject to the reserve requirements set by the Federal Reserve, which had no jurisdiction. The strategy failed as it ultimately drove the market overseas.

On the other hand, it should be acknowledged that derivatives products are not merely another group of capital market instruments, subject to the usual risks. The risks associated with derivatives have been discussed and referred to throughout this thesis. It has been argued in this work that the special qualities or characteristics of these products and the markets in which they are traded, set them apart from other instruments. What distinguishes derivatives from other capital market instruments is their susceptibility to manipulation and fraud,[31] the complexity of some types of derivatives, the large size of individual transactions, their sometime erratic behaviour which causes extreme volatility, their linkages and interconnection with underlying markets and the possibility of a huge and sudden loss.[32] All these factors underline the fact that derivatives markets are fundamentally different from other financial markets.

Further, it has been established in this work that gaps exist in the regulatory framework with the number of unregulated products on the rise as a consequence of the continuous process of market innovation that is taking place. Some OTC derivatives and all exchange traded derivatives are regulated by the Corporations Law, while a number of other OTC derivatives are not. It would be an anomaly if the statutory safeguards available to investors trading in regulated derivatives are not provided also to investors trading in the OTC markets. Such a policy would result in one group of investors being given protection under the Corporations Law while others are left to fend for themselves.

A principal goal of regulation in the financial markets is investor protection and in respect of retail investors, governmental intervention is needed because these investors

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[30] Burns, JP, 'Should the Derivatives Markets be Regulated?', *Applied Derivatives Trading*, Nov 1996. (http://www.adtrading.com/adt8/derive.hts)

[31] Partnoy, F, 'Financial Derivatives and the Cost of Regulatory Arbitrage', *The Journal of Corporate Law*, Vol 22 No 2, Win 1997, 255.

[32] See the discussions by Roberts, RY, 'SEC Corporate Disclosure Issues Regarding Derivatives', in a speech to the New York Society of Security Analysts: Conference on Current Issues in the Derivatives Markets, New York, 17 May 1995 (http:www.gsionline.com/speech/SPCH040.TXT). Richard Roberts, the Commissioner of the US Securities and Exchange Commission, had asserted that derivatives are "somewhat distinctive for both the magnitude and the swiftness with which losses can be incurred."

are in a disadvantaged position. The regulatory framework does not create a level playing field for all investors and as a group, retail investors are not well organised to seek protection for themselves.[33] They are a "diffuse and poorly organised pressure group; management by contrast, is concentrated and well organised, and thus is more likely to carry the day politically."[34] Additionally, retail investors, in general, are at a disadvantage because of their relative lack of resources, knowledge, experience or familiarity with derivatives when compared with larger and well resourced corporations. In view of their relatively poor bargaining position, retail investors need to be protected by the State and this is best achieved through Government regulation.

Another reason in support of regulation is that the derivatives industry is a very competitive industry, where trading is not confined to national boundaries. To gain greater market share or higher profitability, market makers may be preoccupied with developing innovative products to stay ahead of competition or take a bigger risk in leverage transactions. Consequently, they may allocate only token resources to the development and maintenance of a proper risk management system and instead concentrate their resources on making profits or improving their market share.[35] Government regulation will play a useful role in imposing outside controls to protect the market markers, and their investors, from their own imprudent actions.

Although regulation may impose costs on the derivatives industry, regulation can also lower the costs of transactions to market participants.[36] Clear rules such as those dictated by regulation can save the parties the costs which they may otherwise incur in negotiating those terms.[37] Also, from the perspective of the regulators, it has been argued that regulation that imposes direct controls on the behaviour of market participants reduces the need for detailed on-going supervision by regulators.[38] Participants are well aware that if they violate the regulation, they are liable to be penalised. In setting out the rules through regulation, the regulator's task is made easier because the rules constitute a strong incentive for participants to comply.

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[33] Partnoy, F, note 31, 255.
[34] McChesney, FS, 'Economics Law and Science in the Corporate Field: A Critique of Eisenberg', 89 *Colum L Rev*, 1989, 1544 quoted in Macey, JR, 'Derivative Instruments: Lessons for the Regulatory State', *The Journal of Corporation Law*, Fall, 1995, 92.
[35] Garten, HA, *Why Bank Regulation Failed - Designing a Bank Regulatory Strategy for the 1990s*, Quorum Books, New York, 1991, 152. Similar arguments were put forward by the author in relation to the regulation of the banking industry in the United States. It is submitted that the arguments are applicable also to the OTC derivatives markets.
[36] Macey, JR, note 34, 92.
[37] Macey, JR, note 34, 92.
[38] Garten, HA, note 35,153.

For the reasons given above, there appears to be a sound basis for further regulation to rectify the deficiencies in the Corporations Law in relation to OTC derivatives. The question is to what extent should changes be made.

9.5 The Corporations Law reform

A revamp of the regulatory framework is supported in the Wallis Committee's *Financial System Inquiry Final Report,*[39] published in March 1997 and the Companies & Securities Advisory Committee's *Regulation of On-exchange and OTC Derivatives Markets, Final Report,*[40] published in June 1997. It is also supported by the Commonwealth Treasurer in his response[41] to the Wallis Final Report. Although there is a consensus on the need for law reform, it is uncertain as to the form or the extent which regulation on the OTC derivatives market should take.

The strategy for derivatives regulation is important as it would determine how successful any proposed regulation would be. The derivatives market is relatively new and is one which has tremendous potential for growth. Operating in a conducive regulatory environment, derivatives can act as a catalyst to propel faster growth in virtually all sectors of the economy, primarily because they are useful tools for the management of commercial risks. For example, they may be employed by primary producers to hedge against a fall in the price of their products. The key to providing an appropriate framework is the right balance of regulatory mix so that the regime is neither over regulated nor under regulated.

9.5.1 Factors relevant to law reform

There are several pertinent factors which may assist in determining the extent of regulation. These factors, if taken into consideration, could help to establish the parameters for the law reform. Some of these factors are discussed below.

The first is that any regulatory change creates transitional problems[42] as invariably there will be teething problems during the period the regulator and the regulatee adjust to new rules. It follows that the more extensive the changes, the greater would be the adjustments required. During the transition, costs may be increased as personnel from the regulatees undergo training to familiarise themselves with the new requirements.

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[39] Wallis Final Report, note 1, 38.
[40] CASAC Final Report, note 2, 5.
[41] Costello, P, 'Reform of the Australian Financial System: Details of Measures', additional document tabled in association with the Statement by the Treasurer delivered at the House of Representatives, 2 September 1997 (Treasurer's Details accompanying his response to Wallis Committee), 12 (http://www.treasury.gov.au/PressReleases/Treasurer/1997_0102_Details.html)
[42] Garten, HA, note 35, 165.

Initially also, there may be an increase in risk[43] since some of those regulated may experience some difficulty in understanding or complying with the changed rules. The regulator, for its part, needs to develop appropriate strategies:

- to ensure that initial risks are controlled; and
- to achieve the new regulatory objectives.

Second, the absence of regulatory control or inadequate regulatory control over some OTC derivatives markets would make surveillance by the regulators very difficult. Under the existing regulatory framework, the Australian Securities Commission (ASC) has no jurisdiction to supervise those OTC derivatives products not regulated by the Corporations Law and has no jurisdictional powers to call to account those participants who trade in unregulated products and who indulge in undesirable market practices. Without further regulation, some investors - those who trade in unregulated products - will be unprotected.

Third, gaps in the regulatory framework create inconsistency in the policy for investor protection and give rise to regulatory arbitrage as participants seek to maximise their opportunities. Regulatory incentives arising from the largely unregulated state of the OTC derivatives market may be so rewarding that they strongly influence market makers' choice in the selection of a derivatives instrument. For example, a market maker may have a greater incentive to promote a less suitable derivatives product over another more suitable product simply because of the regulatory advantage which that less suitable product enjoys. Regulatory arbitrage ought to be discouraged as it could lead to inefficiencies in the markets.

Fourth, regulation may have unexpected outcomes.[44] Each regulatory strategy could bring with it a separate set of problems. If the rules are too rigid, they may inhibit the growth of the OTC derivatives industry. Inflexible rules may create fresh loopholes for products or situations that do not come within the black lettered laws. A good example is the existing Chapter 7 and Chapter 8 of the Corporations Law which, because of their rigidity, have not been able to accommodate a number of OTC derivatives which do not fall within the definitions of "futures contracts" or "securities", thus giving rise to regulatory gaps. Rigid regulation may also spur the regulatees to look for ways to evade the new rules.[45]

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[43] Garten, HA, note 35, 166.
[44] Garten, HA, note 35, 156-159.
[45] Garten, HA, note 35, 157.

However, if the rules are too flexible, other problems may ensue. Although they are designed to give breadth of application to a range of conduct, a number of problems are identified with 'fuzzy' laws. First, as mentioned briefly in Chapter 8 of this thesis, they can create uncertainty as regards their interpretation and whether a particular set of circumstances is within the ambit of q fuzzy law provision is then subject to be interpreted by the courts. Australian courts are bound by centuries of precedents and the interpretation by the courts may have unexpected results. For instance, in the *Carragreen* Case[46], the decision of the Court in relation to the terms "facility" and "place" meant that routine OTC derivatives transactions among members of a conglomerates may be said to be conducting a "futures market" and therefore are prohibited by section 1123 of the Corporations Law unless an exemption is granted under section 1127 of the Corporations Law.[47] The judgment created unexpected consequences since the legislature, in enacting Chapter 8, had not intended for section 1123 to apply to intra group transactions. Second, flexible regulation is indirect and may depend on creating incentives to induce the regulatees to act in a particular way,[48] and there is no guarantee that the regulatees will oblige. A third difficulty is the perception that fuzzy law succeeds in protecting only the perpetrators of market offences, and not the investors, as the courts interpret penal provision in favour of the alleged offender in case of an ambiguity in a penal statute.[49]

Fifthly, a regulatory policy based on economic concepts may not be entirely suitable in the context of derivatives. As explained in Chapter 2 (Methodology) of this thesis, economic theory is useful in analysing costs and efficiency of regulation but in so far as economic theory is premised on investors exhibiting rational behaviour, that rational behaviour cannot be relied on. Policy makers need to move beyond economic theories to embrace a more holistic approach in framing the new regulation for the derivatives markets.

Sixthly, it is probably easier for conservative participants to take more risks than for aggressive participants to be more prudent.[50] Regulation is useful as it serves as a constant reminder that participants should not take unacceptable risks. Bearing in mind that derivatives are volatile and high risk instruments, there is a good case for more regulation rather than less.

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[46] *Carragreen Currency Corporation Pty Ltd v Corporate Affairs Commission (NSW)* (1987) 5 ACLC 148.
[47] See the discussion on this case in paragraph 5.2.4.3 of this thesis.
[48] Garten, HA, note 35, 157.
[49] Pearce, DC, & Geddes, RS, *Statutory Interpretation In Australia*, Butterworths, Sydney, 1988, 167-170.
[50] Garten, HA, note 35, 161.

Finally, inappropriate regulation may heighten the risks associated with derivatives trading. The failure by the legislature or regulator to understand the true nature of derivatives instruments and the management of derivatives risks could result in an increase in "regulatory risk",[51] that is, risks created by unsuitable regulation or enforcement strategies. Any regulation made must be appropriate to the circumstance for which it is intended.

9.5.2 A minimalist approach to law reform and recommendations

In relation to the extent of law reform to be undertaken, this work canvasses the minimalist approach because at this stage of the evolution process of financial derivatives, any regulatory framework now in place is likely to be regarded as being in transition. As stated in Chapter 1, part of the significance of this thesis is that by identifying the gaps and other deficiencies in the Corporations Law regime and mapping out the extent to which other pieces of legislation are or may be effective substitutes, unnecessary regulation may be avoided.

It is not expected that any law reform carried out now will be the final piece of legislation for several reasons. Innovation on financial derivatives is far from being exhausted. Given the inventiveness of rocket scientists in financial engineering, there is a real danger that any regulation made today will be outdated tomorrow by new developments either in technology or in derivatives products or both. This is because the drafting of appropriate regulation requires an understanding of the nature and types of derivatives and this understanding is likely to be continuously challenged by new developments. Until legislators and regulators understand what derivatives are, it is impossible for them to regulate them effectively.[52] As they mutate and transform into new products, fresh regulatory issues are bound to arise.

Further, globalisation may influence the direction of derivatives regulation. The availability of new technologies has made it possible for investors to purchase derivatives products from the global market place. There is a need for the international community to formulate an investor protection regime beyond the current efforts to enter into co-operative arrangements with other regulators. Commercial reality dictates that Australian regulation be in step with the regulation in force from time to time in other financial centres of the world. In the coming years the regulatory framework is expected to undergo changes as it aligns itself with law reform overseas to maintain its competitiveness.

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[51] Culp, CL, & Mackay, RJ, note 26.
[52] Partnoy, F, note 31, 256.

It is clear from the above discussions that financial derivatives do not lend themselves easily to regulation. Their close linkages with underlying markets have flow through effects so that it is no longer adequate for investor protective measures such as the sanctions regime, to apply to derivatives contracts. Such safeguards need to be extended to the related markets.

Added to the overall difficulty is the policy makers' dilemma that regulation made in respect of derivatives will benefit some investors at the expense of others.[53] An example will be the promulgation of the proposed Close Out and Market Netting Act which will have the effect of depriving creditors of insolvent companies of monies which they may otherwise be entitled to, under the laws of insolvency. Instead, the proposed Act will favour counterparties to derivatives transactions.

Regulation of derivatives is a complex exercise as the policy maker is required to grapple with a myriad of policy issues. Certainly, it could benefit from more analysis and debate.[54] It is hoped that the broad proposals discussed in this thesis, and in particular the recommendations below, will encourage further analysis and discussion by policy makers, regulators, peak bodies, and academics.

Until the evolution of derivatives products stabilises and the regulatory issues are thoroughly debated, effecting minimum changes to the Corporations Law without compromising on investor protection is arguably the better strategy for policy makers, compared to whole scale regulation. Adopting a minimalist approach will reduce both transitional problems and costs.

The analysis in this work on gaps and other deficiencies in the Corporations Law and the comparative study in Chapter 6 of this thesis together with the summary of findings in the last Chapter make it possible to identify areas where changes are necessary to protect investors in the OTC derivatives market. By relying, where appropriate, on criminal and consumer laws as a supplement, this work has also enabled minimum changes to the Corporations Law. This helps to eliminate any unnecessary regulation.

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[53] Macey, JR, note 34, 89.

[54] An important policy issue would be the right regulatory mix between criminal and civil remedies. A meaningful discussion of this issue would entail empirical work and is outside the scope of this thesis.

On the basis of a minimalist approach, it is proposed that Recommendations 2, 4, 6, 16, 21 and 22 of this thesis which are set out below, be adopted. The other recommendations are included and may be considered if a more comprehensive approach is thought desirable.

9.5.2.1 Chapters 7 and 8 of the Corporations Law

As presently defined, the term 'securities' include some forms of derivatives. If securities are separated from derivatives, it will put into perspective the role and function of securities as a capital fund raising instrument and their relationship with derivatives, which is that of an "underlying" asset. Securities such as stocks and shares, by themselves, are not derivatives as they do not belong to any of the basic group - futures, forwards, swaps or options. The current treatment of securities in Chapter 7 of the Corporations Law has caused a blurring of the distinction between securities and derivatives and gives rise confusion. The Wallis Committee's recommendation that Chapters 7 and 8 of the Corporations Law be combined into a single regime has the potential to compound that confusion.[55] This is because the nature and content of the investor protection regime for securities differs from that of derivatives, which in essence, are risk management instruments. As pointed out in the Chapter 8 of this thesis, there are a number of areas where the application of a single regime will be inappropriate,[56] and unless the rules in these areas are crafted to take into consideration the different requirements of securities and derivatives, problems of application will arise. In maintaining a discrete regime for securities, these difficulties[57] will be eliminated.

<u>Recommendation 1</u>

It is recommended that Chapter 7 of the Corporations Law be modified to limit the scope of its operations to securities only.

<u>Recommendation 2</u>

Options over securities and any other forms of derivatives which are currently included in the definition of "securities" should be relocated to Chapter 8 of the Corporations Law.

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[55] This recommendation has the support of the Treasury. See paragraph 8.5 in the previous Chapter of this thesis.

[56] See paragraph 8.3.4.1 of this thesis.

[57] The areas of difficulty have been discussed in paragraph 8.3.4.1 of this thesis.

Recommendation 3

Chapter 8 of the Corporations Law be enlarged to cover all derivatives transactions including OTC derivatives and derivatives over securities such as prescribed interests and options. The rationale for this suggestion has been discussed in the previous Chapter of this thesis.[58]

A criticism which may be levied at maintaining a regime for securities and a separate one for derivatives is the partial duplication of some regulation[59] between securities and futures (derivatives) regulation. One way of addressing this difficulty is to relocate regulation which is common to both regimes to another chapter and have the regulation apply to both securities and derivatives. Alternatively, all three regulations - securities, derivatives and the common regulation - may be located in one Chapter but segregated into separate parts so that securities will be in one part, derivatives in another and common regulation in the third. This alternative proposal for one Chapter to accommodate both securities and derivatives is for convenience and, to all intents and purposes, the securities regime remains separate from the derivatives regime.

9.5.2.2 Definitions

In relation to Chapter 8 of the Corporations Law, it is expected that if the deficiencies in the regime are addressed, it will go a long way to quelling the concerns which now surface in regulatory debates. As most of the gaps in investor protection arise from the rigid and narrow definition of the term "futures contract", a suitable definition of derivatives will assist in closing up many of the regulatory gaps. If a broader and more flexible definition[60] is adopted, it is expected that most, if not all, of the derivatives currently unregulated by the Corporations Law will fall to be regulated under Chapter 8. At the same time, the OTC derivatives will be brought in line with exchange traded derivatives and be regulated under the same regime. Such a strategy will provide more consistent regulation of derivatives. As a consequence, the disclosure and licensing arrangements in the existing Chapter 8 automatically will be made applicable to OTC derivatives, as will the penalties regime.

It is envisaged that other adjustments will need to be made to Chapter 8 of the Corporations Law to accommodate the special characteristics of the OTC markets as not all provisions in Chapter 8 will be suitable for OTC derivatives products. For

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[58] See paragraph 8.3.4.1 of this thesis.

[59] For example, the provisions in the sanctions regime in Chapter 7 is mirrored to a large extent by corresponding provisions in the Chapter 8 sanctions regime.

[60] A detailed discussion of an appropriate definition will be outside the scope of this thesis. The issue of definitions is dealt with by CASAC in CASAC Final Report, note 2, Recommendation 4.

example, it may be necessary to provide modified rules for fidelity fund, clearing houses, clearing rules and clearing margins. It is, however, beyond the scope of this thesis to discuss the details of the modification or changes required.

Also, in the light of the discussion in the previous Chapter[61] on paragraph 72(1)(d) of the Corporations Law, the exclusion of the four classes of contracts from "futures contracts" requires rationalisation. A revised definition of "futures contract" need to take into account that there are other entities prudentially supervised in addition to banks and that there are other classes of contracts traded by those entities which are prudentially regulated.

<u>Recommendation 4</u>

It is recommended that the term "futures contracts" (perhaps to be renamed "derivatives contracts") be redefined to encompass all derivatives instruments, including futures contracts, forwards, swaps, options and derivatives over securities, whether traded on exchange or off exchange.

<u>Recommendation 5</u>

Given the complexity in the current definitions of "securities" and "futures contract" it is suggested that the definitions be simplified in line with the Government's Corporations Law simplification program, now incorporated into the Corporate Law Economic Reform Program.

<u>Recommendation 6</u>

Chapter 8 be amended to provide modified rules for fidelity fund, clearing houses, clearing rules and clearing margins in relation to OTC derivatives.

<u>Recommendation 7</u>

Section 55 of the Corporations Law should be amended by deleting "whether or not" from the definition of a "Chapter 8 right" so that there is consistency in the Law. This would overcome the difficulty created by section 55 which, as it presently stands, would have the effect of rendering an option over a contract which is unenforceable at common law or in equity, to be enforceable.

<u>Recommendation 8</u>

The preferential treatment for the banks granted by paragraph 72(1)(d) of the Corporations Law be abolished or alternatively, be redrafted to take into consideration

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[61] See paragraph 8.2.2.4 of Chapter 8 of this thesis.

other classes of derivatives contracts deserving of exclusion and other institutions which are prudentially regulated.

Recommendation 9

In addition to the proposed changes to Chapters 7 and 8 of the Corporations Law, it is recommended that the proposed Close Out and Market Netting Act[62] be passed to clarify the law on netting. This will provide not only legal certainty but will also reduce credit risks to derivatives participants.[63]

9.5.2.3 Gaps and inconsistencies in the sanctions regimes of the Corporations Law

Paragraph 8.2.3 of Chapter 8 highlighted some areas of inconsistencies between the sanctions regime in Chapter 7 and the regime in Chapter 8 of the Corporations Law, resulting in some conduct being prohibited in Chapter 8 but not in Chapter 7 and vice versa. These anomalies should be addressed.

Further, as the Corporations Law now stands, the sanctions regime in Chapters 7 and 8 does not apply to excluded derivatives contracts in paragraphs 72(1)(d) and 72(1)(e), because not being futures contracts, they are outside the ambit of the Corporations Law. The contracts in paragraph 72(1)(d) alone account for two-thirds of all derivatives contracts traded in this country. Given that this is by far the largest group of unregulated contracts, there is a case for subjecting these excluded contracts to the provisions of the sanctions regime in Chapters 7 and 8 or alternatively the provisions in consumer and criminal legislation.

Recommendation 11

It is recommended that hawking, which under existing legislation is not a proscribed conduct for futures contracts, be made an offence in respect of all derivatives contracts, including futures contracts.

Recommendation 12

It is recommended that Chapter 7 of the Corporations Law be amended to prohibit fraud by a securities broker on its clients much in the same way as fraud by a futures broker is prohibited by section 1264.

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62 Companies & Securities Advisory Committee, Netting Sub-Committee, 'Netting in Financial Markets Transactions, Final Report', June 1997.

63 See the discussion in paragraph 5.5 of Chapter 5 of this thesis.

Recommendation 13

The sanctions regime in the Corporations Law should apply to all derivatives transactions. For this reason all OTC derivatives contracts should be brought within the purview of the Corporations Law. If it is thought that as a matter of policy, certain derivatives contracts ought to be excluded from the operations of the regime in the Corporations Law because one of the parties is prudentially regulated, there should be minimum statutory safeguards to protect counterparties and that the safeguards should include subjecting excluded transactions to a sanctions regime. Alternatively, it is suggested that the provisions in general consumer and criminal laws be expanded to cover those conduct identified in Chapter 6 of this thesis as being totally unregulated.

9.5.2.4 Licensing

Recommendations 14

For the reasons given in paragraph 8.3.1.2, it is recommended that licensing arrangements apply to all derivatives products, including OTC derivatives.

9.5.2.5 Suitability rule

Recommendation 15

It is recommended that a "know your client" rule not be adopted as it will not have a significant impact on investor protection in view of adequate safeguards now existing and in view of additional costs entailed in compliance.[64]

9.5.2.6 Unregulated entities

The need to regulated unregulated entities was discussed in paragraph 8.3.2.

Recommendation 16

It is recommended that the existing supervisory gap be addressed by expanding the role of the ASC to encompass that of a prudential regulator in relation to all entities dealing with retail investors and all wholesale and end users which are public listed corporations (other than those which are specifically exempted or those which are subject to prudential regulation by the RBA, ISC or AFIC).

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[64] It should be noted that CASAC took an opposite view by recommending that the suitability rule applies to personal derivatives recommendation to retail clients: See CASAC Final Report, note 2, 132-135.

9.5.2.7 Prudential regulation

Recommendation 17

It is recommended that prudential regulation, substantially similar to prudential standards to which deposit taking companies are currently subject, be imposed for all market makers as well as all public listed companies, on the basis that the investors in these market makers should be treated no less differently than the investors of banks and other deposit taking companies.

9.5.2.8 Retail investors and exempt market status

Recommendation 18

As the provision of exempt market declaration to retail investors may compromise the level of protection which is required by these investors, it is recommended that any exemption be confined to sophisticated participants.

9.5.2.9 Contravention of gaming and wagering laws

Recommendation 19

For the reasons given in paragraph 8.3.3.3 (b) of Chapter 8, CASAC's recommendation that all transactions on the OTC derivatives markets should be specifically excluded from gaming and wagering legislation is supported. This will help to reduce legal risk due to an unintentional contravention of State gaming and wagering laws.

9.5.2.10 Ultra vires principle

To reduce legal risks attributable to a lack of capacity, it is suggested that the boundary for investor protection be redefined so as to balance the interests of two competing groups, namely, the beneficiaries of trusts or shareholders of corporations on the one hand and the derivatives participants on the other hand. Such a reallocation of risks is not without precedent. The legislature had, as a matter of policy, virtually abolished[65] the ultra vires doctrine in respect of all companies established under the Corporations Law. In enacting the existing sections 160, 161 and 164 of the Corporations Law, it has shifted in favour of persons with whom companies contract, the policy boundary that divided protection for shareholders of the companies and protection for persons (such as creditors) with whom those companies contract.

[65] See sections 160 and 162(5) of the Corporations Law but subject to subsection 164(4) where actual or constructive knowledge could bring alive the doctrine.

Recommendation 20

A provision may be inserted into the Corporations Law along the lines of section **1141** to the effect that nothing in a law of a jurisdiction about the capacity of a party to enter into a derivatives contract would prevent the entering into of or affects the validity or enforceability of a derivatives contract.

9.5.2.11 Insolvency laws

Recommendation 21

The proposed netting legislation (Close Out and Market Netting Act) is highly recommended since it will serve not only to improve investor protection against credit risks but also against legal risk arising from the operation of insolvency laws.

9.5.2.12 Regulators

Recommendation 22

The recommendation of the Wallis Committee in establishing a single national prudential regulator be adopted. The RBA be nominated to assume that role of the national prudential regulator, the APRC.

Recommendation 23

The recommendation of the Wallis Committee in establishing a national regulator, the Corporations and Financial Services Commission, which has responsibilities, among other things, for consumer protection function be supported. The ACCC (and not the ASC as proposed by the Wallis Committee) should be the regulator.[66]

9.6 Conclusion

This work has established that there is a case for law reform in the area of investor protection. It has identified a number of regulatory gaps and deficiencies, which if left unattended, could seriously undermine the regulatory objective encapsulated in paragraph 1(2)(b) of the *Australian Securities Commission Act 1989* (Cth) which is to maintain the confidence of investors in the securities and futures markets.

Current regulation has failed investors trading in unregulated OTC derivatives by not providing them with the statutory safeguards which are available to investors trading on organised exchanges. Measures, such as those recommended above, must be devised to address the gaps and deficiencies in the Corporations Law. In adopting the recommendations made in this thesis, the legislature will not only level the playing field

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[66] The reasons were discussed in paragraph 8.4.2.1 of this thesis.

for all investors of the derivatives markets but will also help to reduce systemic risks by bringing the sanctions regime to bear on the participants in the OTC derivatives markets.

Derivatives trading is not confined to Australia nor is the Australian financial markets isolated from the international capital markets. The economic stakes are high and the costs to a country large if business is lost to overseas financial centres due to the perceived deficiencies in its regulatory system - an outdated, inflexible and inadequate regulatory framework which leaves investors in the OTC derivatives markets very much unprotected. For this reason it is important that the current momentum and enthusiasm for regulatory changes be maintained.

The path to law reform appears well established with recommendations and proposals from the Wallis Committee, CASAC and Treasury. Despite these recommendations or proposals, it may well be that this is not the time for comprehensive law reform in view of the unsettled state of derivatives.[67] More work needs to be done in a number of other areas. For example, the overall impact that electronic and cross border trading have on the protection of individual investors would profit from further study.[68] So too, would the implications of "flow through" effects which movements in prices of derivatives have on the prices of underlying assets. The inter-connections between derivatives markets and their related markets raise concerns as manipulation of the physical markets could create price fluctuations in the derivatives markets and vice versa. The global nature of derivatives demands that such issues be factored into the design for a regulatory structure.

Also, voluntary codes of practice could conceivably establish an acceptable framework for commercial conduct and practice in dealing with unregulated derivatives products.[69] The discipline of market forces could provide yet another control over

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[67] The United States is still in the process of debating on the regulatory challenge posed by energy derivatives, including electricity futures contracts which began trading in the United States on 29 March 1996. Amendments proposed to the Commodity Exchange Act has been criticised as compromising the regulator's ability to protect investors and preserve market integrity. See Dial, JP, 'Energy Derivatives: The Regulatory Challenge of a Global Marketplace', remarks of Joseph P Dial, Commissioner of Commodity Futures Trading Commission at Maguire Oil and Gas Institute: Energy Policy Symposium "Managing Risk in Energy Markets", 7 March 1997 (http://www.cftc.gov/opa/dial-69.html).

[68] The Treasury's paper entitled 'Electronic Commerce', referred to in f/n 142 in Chapter 8 of this thesis is a policy paper and not a research paper. The issues raised therein would benefit from additional work.

[69] Companies & Securities Advisory Committee, 'Regulation of the OTC Derivatives Market, Discussion Paper', 1995 (CASAC OTC DP), 17.

market participants.[70] The impact which these other mechanisms of control over derivatives participants deserves further study and consideration.

This is not to suggest that changes are to be frozen until all issues are studied. While caution is warranted, the time is certainly ripe for a rethink of the current regulatory policy and, as an interim measure, for effecting the minimum changes advocated in this thesis so that, at the very least, the regulatory gaps in investor protection are addressed. It is submitted that the minimalist approach advocated in this Chapter and the recommendations made will help to fill the gaps in investor protection identified in earlier Chapters in the analysis of the regulatory framework.

Two other points need to be made in conclusion. The first is the contributions made by this thesis which assist in increasing the store of knowledge on OTC derivatives regulation in several areas. First, in building on the work of recent reports on regulatory gaps by carrying out a systematic examination of Chapters 7 and 8 of the Corporations Law, this thesis is able to provide a more comprehensive identification of regulatory gaps than undertaken to date. Although gaps have been discussed in a number of reports published by the Australian Securities Commission and by the Companies and Securities Advisory Committee, the identification of gaps in these reports is ad hoc in nature and lacks systematic analysis.[71] Second, by mapping out the extent to which the Corporations Law regime apply to OTC derivatives contracts, this work shows how OTC derivatives fit into the existing regulatory framework. Third, the detailed comparative analysis (of the sanctions regime in Chapters 7 and 8 of the Corporations Law and parallel provisions in the *Trade Practices Act 1974* (TPA)) undertaken in Chapter 6 of this thesis lays the groundwork for private parties, if they wish, to employ section 52 of the TPA as a remedy against those who have indulged in manipulative and abusive market practices. So far, such an analysis has not been undertaken before. Fourth, this work provides a basis upon which a realistic assessment could be made as to whether the existing system is adequate to protect investors. The identification of gaps in the Corporations Law framework and in the supervisory structure pin points the deficiencies in the current regulatory system while the identification of the extent of overlap between the sanctions regimes in the Corporations Law and the corresponding regime in consumer and criminal legislation narrows the regulatory gap, thus exposing true gaps where investors arguably are unprotected by any legislation. Fifth, the identification of unregulated products, the size of the market for those products, the extent to which consumer and criminal laws

[70] CASAC OTC DP, note 69, 16.
[71] See for example the discussion on regulatory gaps in CASAC OTC DP, note 69, 16, which merely referred to a couple of options as evidence of gaps.

are capable of compensating for the gaps in the Corporations Law, makes it possible for policy makers to provide adequate investor protection using the minimalist approach.

The second point is that one must be cautious in viewing the regulatory structure purely from one angle. In concentrating on investor protection, this thesis deals with but one set of values. There are other values which are equally important and therefore investor protection must be looked at from a wider context. An exemplary regulatory structure includes such criteria as flexibility, that is, an ability to respond to changing market environment and the ability to maintain a fair and orderly market. A more holistic understanding of the regulatory system and its weaknesses is possible only if the system is assessed against criteria other than those for investor protection.

A major revision of the law on derivatives is a costly exercise and is justifiable only after its effectiveness and usefulness have been properly evaluated and thoroughly examined. Until then, it is submitted that the pragmatic approach would be simply to address the major gaps identified in this thesis by effecting only those minimum changes recommended in this Chapter. In such a fast changing landscape as financial derivatives, with its manifold problems, uncertainties and complexities, incrementalism appears to be the only viable solution.

It is submitted, with the greatest respect, that the proposals contained in the Treasury's Position Paper, discussed in the preceding Chapter of this thesis, are too broad to be implemented without a comprehensive study of their implications. Academic writers in recent years have expressed concern about the quality of research behind reports and discussion papers relating to law reform.[72] It is recommended that regard be had to these observations in the process leading up to the final legislation for the derivatives and other financial products.

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[72] Tomasic & Bottomley in their book, Tomasic, R & Bottomley, S, *Directing the Top 500,* Allen & Umvin, Singapore, 1993, have pointed out at page 166 that not only is there little apparent coordination between the reports, there is also considerable variation in the quality of research behind them while Ian Ramsay observed, in connection with the Lavarch Committee Report, that a major problem with that report is that because it attempted to cover so much ground, none of the subjects discussed in the Report had been given thorough consideration: see Ramsay, I, 'The Lavarch Committee Report on Corporate Practices and the Rights of Shareholders: Some Problematic Recommendations', 1 *BCLB*, 1992, 5, at 6 &12 quoted by Tomasic, R & Bottomley, S, 166.

APPENDIX 1

ANALYSIS OF SECTIONS 52 AND 53 OF THE *TRADE PRACTICES ACT 1974* (CTH)

A.1 Introduction

The analysis of sections 52 and 53 of the Trade Practices Act 1974 (Cth) (TPA) in this Appendix forms part of the overall analysis carried out in Chapter 6 of this thesis to determine the extent to which the TPA may be an effective substitute for the sanctions regime in the Corporations Law. These sections merit detailed examination as arguably, they constitute the most important statutory safeguard for consumer protection. For this reason, this Appendix is devoted to a discussion of sections 52 and 53 TPA.

A.2 Investor Protection Under the Trade Practices Act 1974

Consumer protection under the *Trade Practices Act 1974* (TPA) is to be found in Parts IV, IVA and V. These Parts are aimed at controlling unfair practices against consumers and promoting fair trading.[1] However, in the context of financial derivatives, the provisions which are of particular relevance are sections 45 (arrangements affecting dealings or competition), 45A (arrangements in relation to prices), 46 (misuse of market power) and 50 (prohibition of acquisitions that would result in a substantial lessening of competition) in Part IV, section 51AB (unconscionable conduct) in Part IVA and sections 52 (misleading or deceptive conduct) and 53 (false representations) in Part V. As indicated in the introductory paragraph, the analysis in this Appendix is confined only to sections 52 and 53 TPA. Sections 45, 45A, 46, 50 and 51AB TPA have been analysed in Chapter 6 of this thesis.

A.3 Section 52 (misleading or deceptive conduct)

The most important source of consumer protection in the TPA is to be found in Part V. This Part prohibits misleading or deceptive conduct as well as sharp practices with the objective of eliminating unfair practices.[2] The principal provision is section 52 which, because it is so widely drafted and because it is morally neutral,[3] not being dependent for its success on evidence of fault or intent or failure to exercise reasonable

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[1] Duns, J & Davidson, MJ, *Trade Practice and Consumer Protection: Cases and Materials*, Butterworths, Adelaide, 1994, 1.

[2] See *Parkdale Custom Built Furniture Pty Ltd v Puxu Pty Ltd* (1982) ATPR 40-307 per Mason J at 43,786 referred to in Steinwall, R & Layton LP, *Trade Practices Act*, Butterworths, Sydney, 1995, 115.

[3] Samuels JA in *Commonwealth Bank of Australia v Mehta* (1991) ATPR 41-103 at 52,600-52,601.

care, has been one of the most utilised of statutory provision. Section 52 has been employed in a range of situations in contractual or tortious setting and, as the analysis below shows, it could be used as an alternative to most of the offence provisions in Chapters 7 and 8 of the Corporations Law which have been identified in the first part of Chapter 6 of this thesis as being relevant to investor protection. A contravention of the section does not give rise to criminal liability[4] although civil remedies including injunctive remedies under subsection 80(1)(a) TPA, damages[5] under subsection 82(1) TPA and a host of other orders under section 87 TPA are available to an aggrieved party.

Section 52 provides as follows:

> "A corporation shall not, in trade or commerce, engage in conduct that is misleading or deceptive or which is likely to mislead or deceive."

To determine the extent of its application to derivatives, it would be necessary to examine the meaning of key terms in subsection 52(1). At first sight, it would appear that this subsection only governs the conduct of corporations. The term "corporation" is defined in section 4 to mean:

> "a body corporate that:
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> (a) is a foreign corporation;
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> (b) is a trading corporation formed within the limits of Australia or is a financial corporation so formed;
>
> (c) is incorporated in a Territory; or
>
> (d) is the holding company of a body corporate of a kind referred to in paragraph (a), (b) or (c)."

However, it has a much broader scope and in certain cases will apply to individuals, by virtue of sections 5 and 6 TPA. These two latter sections extend the ambit of subsection 52(1) TPA to cover natural persons in the following cases:

- where the conduct is outside Australia (section 5(1));
- where the trade is interstate trade (section 6(2)); or
- where the conduct involves the use of postal, telegraphic or telephonic service (section 6(3)).

The OTC derivatives market is dominated by participants who are banks and trustees of superannuation funds or insurance companies, virtually all of which are companies

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[4] See the exclusion in section 79(1) TPA.

[5] Damages may be statute barred if an action is not commenced within 3 years after the cause of action accrues: subsection 82(3) TPA.

within the meaning of "corporation" in section 4 TPA. The extension to individuals in situations within sections 5 and 6 merely serves to increase the scope of section 52 further. Although it is conceded that sections 5 and 6 TPA may not cover individuals in all situations, this would not cause a regulatory gap because all the eight States and Territories namely, New South Wales, Victoria, Queensland, Western Australia, South Australia and Tasmania have enacted the Fair Trading Act with a provision similar to section 52 TPA.[6] The State enactments have simply replaced the word "corporation" with "individual."[7]

The only apparent fetter placed on the section is its restriction to conduct in connection with "trade or commerce". The phrase "trade or commerce" is defined in section 4 TPA to mean trade or commerce within Australia or between Australia and places outside Australia. "Trade" is not defined in TPA. It is, however, said by Bowen CJ in *Re Ku-ring-gai Co-Operative Building Society (no 12) Ltd*[8] to include "intangibles, such as banking transactions." On this interpretation, "trade" in section 52 would catch OTC derivatives as they are "intangibles" and most of them are also "banking transactions" in that the OTC derivatives market is dominated by banks. Similarly, "commerce" is not a defined term in the TPA. Like "trade", it is not a term of art but "of the widest import".[9]

What causes concern is not so much the meaning of "trade or commerce" but rather the requirement that the conduct proscribed must be "in" trade or commerce. This phrase was examined by the High Court in *Concrete Constructions (NSW) Pty Ltd* v *Nelson*.[10] The majority of the Court thought it "plain that s. 52 was not intended to extend to all conduct ... in which a corporation might engage in the course of ... its overall trading or commercial business...What the section is concerned with, is the conduct of a corporation towards persons, be they consumers or not, with whom it (or those whose interests its represents..) has or may have dealings in the course of those activities which... bear a trading or commercial character." Financial derivatives transactions are entered into by companies in the course of their commercial activities and there is no doubt that these transactions, being financial instruments, bear a trading or commercial character. That being the case the question as to whether a dealing in

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6 Section 42 of *Consumer Affairs and Fair Trading Act 1990* (NT); section 10 of the *Fair Trading Act 1987* (WA); section 38 of the *Fair Trading Act 1989* (Qld); section 14 of the *Fair Trading Act 1990* (Tas); section 12 of the *Fair Trading Act 1992* (ACT); section 11 of the *Fair Trading Act 1985* (Vic); section 42 of the *Fair Trading Act 1987* (NSW); section 56 of the *Fair Trading Act 1987* (SA).

7 See Duns, J & Davidson, MJ, note 1, 684.

8 (1978) 36 FLR 134 at 139, quoted with approval by the Federal Court in *Bevanere Pty Ltd v Lubidineuse* (1985) 7 FCR 325; 59 ALR 334.

9 per Deane J in *Re Ku-ring-gai Co-Operative Building Society (no 12) Ltd* (1978) 36 FLR 134, 167.

10 (1990) 92 ALR 193.

OTC derivatives, or indeed any financial derivatives, could be said to be a dealing "in trade or commerce" within the meaning in subsection 52(1), would be answered in the positive.

The next key phrase "engage in conduct" would have the meaning ascribe to "engaging in conduct" in subsection 4(2) TPA. This subsection defines the phrase to mean "doing or refusing to do any act, including the making of, or the giving effect to a provision of, a contract or arrangement, the arriving at, or the giving effect to a provision of, an understanding or the requiring of the giving of, or the giving of, a covenant." The definition provided would encompass the range of acts and omissions contemplated by the offences provisions in Chapters 7 and 8 of the Corporations Law. This appears also to be the view of the authors of the Australian Trade Practices Reporter, Vol 2, CCH, 1990 who commented in paragraph 20-120 under the sub-heading "engage in conduct" that "there is no reason to limit conduct to that associated with the supply of goods or services. The supply of "shares" (which do not fall into the definition of goods,[11] and arguably not services either) would seem to be engaging in conduct."

As regards "misleading or deceptive conduct", Section 52 has been used with success[12] in a number of cases concerning foreign currency loans and futures contracts. For example, a businessman successfully sued Westpac Banking Corporation for damages under section 52 TPA in respect of financial advice given by Westpac on risks in taking off-shore loans.[13] In *Re Harold William Ferneyhough and Ors* v *Westpac Banking Corporation,*[14] Westpac made an off-shore lending to the plaintiffs in Swiss franc in June 1984 in an amount equivalent to AUD1.1 million. By late 1987, the amount needed to repay the Swiss franc loan has risen to AUD 2.3 million primarily because of the depreciation of the Australian Dollar against the Swiss franc.[15] The Federal Court held that Westpac failed to adequately explain to the plaintiffs the true nature and quality of the risks involved in taking a foreign currency loan and because of that failure, the plaintiffs were misled. The Court cited with

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[11] It is submitted, with respect, that this comment is not strictly correct as the definition of "goods" in section 4 TPA is a definition by inclusion. Neither shares, futures contracts nor other derivatives products have been excluded and arguably therefore, these personal properties are within the term "goods".

[12] There have also been unsuccessful cases, including the High Court case of *David Securities Pty Ltd v Commonwealth Bank of Australia* (1990) 93 ALR 271.

[13] *Chiarabaglio v Westpac Banking Corporation* (1989) ATPR 40-971, referred to in Duns, J & Davidson, MJ, note 1, 581.

[14] Federal Court of Australia, judgement delivered on 18 November 1991 (unreported). This case is available on SCALE.

[15] On the date of drawdown in 1984, the exchange rate AUD/CHF was 2.0478. By November 1987 when the loan was settled, the exchange rate AUD/CHF was 0.9446.

approval the following passage of Samuels JA in *Commonwealth Bank of Australia* v *Mehta:*[16]

> "...in the factual context of this case, any explanation concerning the risks and the loan which omitted information which a borrower of a foreign currency would need to know and was thus inadequate, might be likely to mislead or deceive... If the conduct involves, as here, the provision of an explanation, it must adequately convey the information which the recipient reasonably expects to receive. If it does not, it may constitute a breach of s 52.."

In *Elizabeth Denison and Juliet Denison* v *Ace Shohin (Australia) Pty Ltd, David Hughes and John Tan,*[17] another unreported Federal Court case, the facts were that Mrs E Denison was introduced to speculative commodity trading by Mr Hughes, an employee of Ace Shohin, a commodities broker. The Court found that Ace Shohin had represented to E Denison that if she acquired futures contracts through it as a broker there was little risk of her making a loss because of the experience and competence of Ace Shohin. The Court found the representation "false, misleading and deceptive." On this and other grounds, the Court held that the contravention of section 52 had been established.

Guidelines on whether an act or omission falls within section 52 TPA was set by the full Federal Court in *Taco Company of Australia Inc. & Anor v Taco Bell Pty Ltd & Ors.*[18] The court's view was that there can be no breach of section 52 unless the conduct constitutes a misrepresentation.[19] The tests (Taco's tests) formulated by the Court to determine whether a conduct is within section 52 TPA may be summarised as follows:

- Identify the relevant section of the public by reference to whom the question of whether conduct is or likely to be misleading or deceptive falls to be tested;
- Consider the conduct by reference to all those who come within it, including the astute and the gullible;
- Determine if some person has in fact formed an erroneous conclusion. Such evidence is indicative but does not of itself establish that the conduct is misleading or deceptive; and
- Inquire why proven misconception has arisen in order to evaluate they are confused because of misleading or deceptive conduct on the part of the "offender".

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[16] (1991) ATPR 41-103.
[17] (No G179 of 1985), judgement delivered on 17 July 1987 by the Federal Court of Australia (unreported).
[18] (1982) ATPR, 40-303 at 43,751-43,752.
[19] the Australian Trade Practices Reporter, Vol 2, CCH, 1990, 14,654.

Section 52 has the potential for being used as an alternative to financial derivatives covered by sections 997 and 1259 (manipulation of the securities market and the futures market), 998 and 1260 (false or misleading appearance of active trading); and 999 and 1261 (false or misleading statement in relation to securities or futures contracts which is likely to induce sale or purchase of securities or futures contracts). It would also be applicable to sections 995 (misleading or deceptive conduct) and 996 (false or misleading statement in a prospectus). These two latter sections will not be discussed as they are more relevant to securities than to derivatives.

'A.3.1 *Section 52 TPA vis a vis section 997 (manipulation of the securities market) and section 1259 (manipulation of the futures market) of the Corporations Law*

The crux of the issue is whether the manipulation of the securities or futures market, in the manner proscribed by sections 997 and 1259, could constitute misleading or deceptive conduct under section 52 TPA. The gravamen of the offence in both sections 997 and 1259 is the entering into transactions to buy or sell a securities or futures contract with the intention to induce other persons to buy or sell the securities of a particular company or futures contracts. The entering into transactions would be doing an act within the meaning of "engaging in conduct" as defined in subsection 4(2) TPA. To contravene sections 997 and 1259, it would also be necessary for that act (ie the entering into transactions) to be accompanied by the requisite mens rea. If such acts are deliberately carried out in the market to provide misleading appearance of a particular price so as to induce others to buy or sell, they would be misleading behaviour and would constitute misleading or deceptive conduct in section 52 TPA. However, in relation to corners and squeezes, the conduct involved in these manoeuvres would not appear to be misleading or deceptive, according to Taco's tests. The shortsellers were already in the market and they were not confused because of misleading or deceptive conduct on the part of the manipulator. The offensive conduct is nothing more than purchasing large quantities of the target stock or futures contracts and holding off selling to the short sellers (who would be desperate to buy to cover their positions) until an artificially high price is reached. Although such conduct is repugnant, it is neither misleading or deceptive.

'A.3.2 *Section 52 TPA vis a vis sections 998 and 1260 of the Corporations Law (false or misleading appearance of active trading)*

Subsections 998(1) and 1260(1) prohibit a person from creating a false or misleading appearance of active trading in any securities or futures contracts on organised markets or with respect to the price of any securities or futures contracts. Additionally subsections 998(3) and 1260(2) forbid the use of fictitious or artificial transactions or

devices to maintain, inflate, depress, or cause fluctuations in, the price for dealings in securities or futures contracts.

Section 52 TPA would have the potential of being used against offenders who are in breach of sections 998 and 1260 if those offenders "engage in conduct that are misleading or deceptive." A requirement of the offence provisions is that a person must be shown to have "created" a false or misleading appearance of active trading (in subsections 998(1) and 1260(1)) or to have "maintained", "increased" or "reduced" market price of securities or futures contracts by fictitious or artificial transactions or devices (in subsections 998(3) and 1260(2)). The actions contemplated would constitute the doing of an act within the meaning of "engaging in conduct" as defined in subsection 4(2) TPA.

The second requirement of the offences, namely, creating "a false or misleading appearance" of active trading in respect of subsections 998(1) and 1260(1) or maintaining, increasing or reducing market prices by "fictitious or artificial transactions or devices" in respect of subsections 998(3) and 1260(2), would be "misleading" within the meaning of section 52 TPA. This conclusion is reached on the basis that the conduct complained of in sections 998(1) and 1260(1) by prescription must be "misleading". As regards subsections 998(3) and 1260(2), the use of "fictitious or artificial transactions or devices" by the offender would be conduct that is misleading or deceptive. This conclusion is supported by the dicta of Stephen J who commented in *Hornsby Building Information Centre Pty Ltd & Anor* v *Sydney Building Information Centre Ltd*[20] that "...sec. 52(1) ... is concerned with consequences as giving to particular conduct a particular colour. If the consequences is deception, that suffices to make the conduct deceptive"[21] and of Murphy J who observed in the same case that "(c)onduct is deceptive or misleading if it has a capacity or tendency to mislead or deceive; intention to mislead or deceive is not required."[22]

It would therefore appear that the conduct impugned by sections 998 and 1260 would also be proscribed under section 52 TPA.

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[20] *Hornsby Building Information Centre Pty Ltd & Anor v Sydney Building Information Centre Ltd* (1978) ATPR 40-067 (Hornsby Case).

[21] Hornsby Case, note 20, 17,690.

[22] Hornsby Case, note 20, 17,693 quoted in the Australian Trade Practices Reporter, Vol 2, CCH, 1990, 14,698-14,711.

A.3.3 *Section 52 TPA vis a vis section 999 and section 1261 of the Corporations Law (false or misleading statement in relation to securities or futures contracts)*

These sections, 999 and 1261, renders it an offence to make a statement or disseminate information that is false or misleading in a material way and which is likely to induce the sale or purchase of securities or induce dealings in futures contracts if at the time of making the statement or disseminating the information, the person does not care if it is true or false or the person knows or ought reasonably to know that the statement is materially false. The making of a false or misleading statement is clearly "misleading or deceptive conduct" within the meaning of section 52 TPA, particularly when, as in sections 999 and 1261, the conduct is either reckless or intentional. It is submitted that the circumstances which give rise to a contravention of sections 999 and 1261 of the Corporations Law will also cause a similar contravention of section 52 TPA.

A.3.4 *Section 52 TPA vis a vis section 1000 and section 1262 of the Corporations Law (fraudulently inducing person to deal in securities or futures contract)*

The main element of the offences in sections 1000 and 1262 is either the dishonest concealment of material facts or the making or publishing of any statement, promise or forecast that the maker knows to be misleading, false or deceptive in a material aspect. The dishonest concealment of material facts, involving as it does the element of "dishonesty" clearly would be "deceptive" conduct under section 52 TPA and the making or publishing of any statement, promise or forecast that the maker knows to be misleading, false or deceptive would be "misleading or deceptive" conduct.[23]

A.3.5 *Section 52 TPA vis a vis section 1001 and section 1263 of the Corporations Law (dissemination of information about illegal transactions)*

Sections 1001 and 1263 strike at predicting movement of the price of securities or futures contracts by circulating information about illegal market rigging activities. The circulating of information about illegal market activities which is taking place or about to take place is not misleading per se, if such an activity is or will be a reality. In relation to the dissemination of information of future illegal activities, section 51A(1) TPA[24] deems a representation as to a future matter to be misleading if the corporation

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[23] See paragraph A.3.2 above and, in particular, the discussion on the dicta of the court in Hornsby Case, note 20.

[24] Parallel provisions in the States legislation are s 41 of *Consumer Affairs and Fair Trading Act 1990* (NT); section 9 of *the Fair Trading Act 1987* (WA); section 37 of the *Fair Trading Act 1989* (Qld); section 11 of the *Fair Trading Act 1990* (Tas); section 11 of the *Fair Trading Act 1992* (ACT); section 10A of the *Fair Trading Act 1985* (Vic); section 41 of the *Fair Trading Act 1987* (NSW);

does not have reasonable grounds for making that representation. If it has, the conduct proscribed under sections 1001 and 1263 will not give rise to a cause of action under section 52 TPA.

Given that speculators are not gullible, it is expected that in most cases, the manipulators would be compelled to enter the market to provide evidence of unusual market activity in an attempt to convince the speculators to trade in the market and thereby to provide them, the manipulators, with the opportunity to reap rich profits. Speculators will trade if they are of the view that the illegal market activities would fuel price increases further, enabling them also to profit. In this scenario, the corporation would have reasonable grounds for making that representation because the illegal activities is taking place or about to take place. Whether in fact any manipulator would ever be so imprudent as to provide proof of reasonable grounds (and thereby subject itself to the prospect of prosecution under section 1001 or 1263) is not the issue. What is important here is that section 52 TPA would not be available against the manipulator if the illegal market activities actually takes place.

However, if the dissemination of information is on illegal activities which are not intended to be carried out, then such conduct would be misleading conduct under section 52 TPA and would be in contravention of this provision.

'A.3.6 Section 52 TPA vis a vis section 1264 (fraud in connection with dealings in futures contracts) and section 1266 (sequence of transmission and execution of orders)

The offence in section 1264 is constituted by a broker or its agent defrauding, misleading or deceiving its clients either deliberately or recklessly. It is clear from a reading of section 1264 that the circumstances which would be a contravention of that provision would likely also be an infringement of section 52 TPA, given the similarity of the conduct impugned by both provisions, except where fraud is the subject matter of the complaint in section 1264. Whether fraudulent conduct in section 1264 is misleading or deceptive within the meaning of section 52 TPA will depend on the facts of a particular case. Frontrunning,[25] a practice which section 1266 seeks to prohibit, may amount to fraud,[26] but that conduct is not necessarily misleading or deceptive. This is because the client did not in fact form an erroneous conclusion by reason of any misleading or deceptive act of the broker when he or she first placed orders with the

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section 54 of the *Fair Trading Act 1987* (SA).

[25] Frontrunning involves a broker taking advantage of a market situation to favour the broker's house orders over client orders.

[26] Currie, JS, *Australian Futures Regulation*, Longman Professional, Melbourne, 1994, 237

broker's house. In other words, the causation which is crucial to a case under section 52, is missing.[27] As previously noted, section 1266 is concerned with on exchange trading and is unlikely to be of much relevance in the OTC markets.

A.4 Section 53 (false representations)

Section 53 TPA focuses on the supply of goods or service by requiring such supplier, inter alia, not to represent that goods or services have performance characteristics, uses or benefits they do not have. In view of the general nature of the language used in section 53, it is conceivable that this provision could apply to derivatives trading and, in particular, to intermediaries selling derivatives products. The section is limited to false or misleading representation and is accordingly much narrower in scope than section 52 which deals with "conduct". Another difference between the two sections is that a contravention of section 53 gives rise to criminal liability[28] while section 52 merely sets a norm for conduct,[29] a breach of which section - as noted above - attracts only civil liability.

The essential part of section 53 reads:

> "A corporation shall not, in trade or commerce, in connection with the supply or possible supply of goods or services or in connection with promotion by any means of the supply or use of goods or services -
>
> (a) falsely represents that goods are of a particular... value..;...
>
> (aa) falsely represents that services are of a particular... value..;
>
> (bb) falsely represents that a particular person has agreed to acquire goods or services;...
>
> (e) make a false or misleading representation with respect to the price of goods or services; ...
>
> (f) make a false or misleading representation concerning the need for any goods or services; ..."[30]

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[27] *See Taco Company of Australia Inc. & Anor* v *Taco Bell Pty Ltd. & Ors* (1982) ATPR, 40-303 at 43,750 per Deane and Fitzerald JJ.

[28] By virtue of section 79 TPA, all offences in Part V are punishable on conviction in the case of a person, by a fine not exceeding $40,000 and in the case of a company, by a fine not exceeding $200,000. There are a few exceptions but section 53 is not among them.

[29] *Jenkins v NZI Securities Australia Ltd.* (1994) ATPR 41-349.

[30] Parallel State provisions are to be found in section 44 of *Consumer Affairs and Fair Trading Act 1990* (NT); sections 12(1) & 13 of *the Fair Trading Act 1987* (WA); section 40 of *the Fair Trading Act 1989* (Qld); section 16 of the *Fair Trading Act 1990* (Tas); section 14 of the *Fair Trading Act 1992* (ACT); section 12 of the *Fair Trading Act 1985* (Vic); section 44 of the *Fair Trading Act 1987* (NSW); section 58 of the *Fair Trading Act 1987* (SA).

"Supply", a key term, means "provide, grant or confer" when used in relation to services, and means supply by way of sale, exchange, lease or hire when used in relation to "goods".

The words "trade or commerce" have been considered under A.3 in relation to section 52 TPA and will not be discussed here. It is sufficient to keep in mind that financial derivatives, being financial instruments, bear a trading or commercial character and a transaction involving derivatives would be a dealing "in trade or commerce."

"Goods" is defined to include vehicles, animals, minerals, crops, gas and electricity. Of greater relevance is the term "services" which is defined broadly to include rights, benefits, privileges or facilities that are provided, granted or conferred in trade or commerce. Such a definition would encompass financial derivatives contracts, all of which would fall within the description of granting a right, privilege or facility. Additionally, the term includes any rights granted or conferred under a contract between a banker and a customer entered into in the course of the carrying on by the banker of the business of banking. Derivatives are now a part of mainstream banking activities and would be part of the "services" of the banks.

"Represent" or "representation" is not a defined term in TPA. However, "representation" is generally accepted to be wider than mere statements and that the acts which might constitute a representation in section 53 TPA was not closed.[31] Whether a representation is made is a matter of fact.[32] The meaning of the word was elaborated on by Deane J in *Thompson v Riley McKay Pty Ltd*:[33]

> "It is implicit in the ordinary use of the word 'represent' that there be an intended representee, to whom the relevant representation is directed. That intended representee may be an identified person, as in the case of a representation made to particular person in a letter or unidentified, as is commonly the case with the representation made in an advertisement... There is not, however, implicit in the word 'represent' any requirement that the representation actually reach or be understood by, the intended representee. The act of representation is complete once the subject matter is irrevocably set forth or disseminated upon the course which is intended to lead to the intended representee or representees."

[31] See discussions in Australian Trade Practices Reporter, Vol 2, CCH, 1990, 15,552.
[32] Steinwall, R & Layton LP, note 2, 140 citing as authority *Barton v Croner Trading Pty Ltd* (1984) 3 FCR 95.
[33] (1980) ATPR 40-152 at 42,174. The passage was quoted in Steinwall, R & Layton LP, note 2, 145.

The word "false" was considered in *Given* v *CV Holland (Holdings) Pty Ltd.*[34] Franki J in the course of his judgement said in discussion on section 53(a) TPA:

> "I am satisfied that, if a representation is in fact not correct, it comes within the words of the section, even if it is not false to the knowledge of the person making the representation."

Section 53 is a "strict liability" offence in that the mental fault element need not be proved. For the purposes of the analysis in the following paragraphs, a three stage process will be used. The conduct prohibited under the Corporations Law will be examined to determine if (1) the proscribed conduct could be a representation; (2) such a representation is false; and (3) the proscribed conduct is in relation to the supply of derivatives contracts or alternatively is in connection with the promotion of goods or services by any means.

It is important to note that not only is misrepresentation in connection with the "supply or possible supply" of goods or services an offence under section 53, it is as much an offence if misrepresentation is made in connection with ***promotion*** of goods or services, "by any means". It will be shown that some offences in the Corporations Law, which would not be caught under the first limb of section 53 in relation to "supply" could however be caught by the second limb under the phrase "by any means".

A.4.1 Section 53 TPA vis a vis section 997 (manipulation of the securities market) and section 1259 (manipulation of the futures market) of the Corporations Law

The issue which requires analysis is whether the manipulation of the securities or futures market by means of buying or selling securities or futures contracts with the intention to inducing others to buy or sell those securities or futures contracts, as prohibited by sections 997 and 1259, could be deemed to be "misrepresentation" under section 53(aa) TPA. In essence these sections seek to prevent the entering into or carrying out of transactions so as to create false or artificial prices and are directed at curbing malpractices including corners and squeezes. Could an infringement of these sections be also an contravention of section 53(f) in that the conduct falls within "in connection with the supply or possible supply of goods or services .. make a false or misleading representation concerning the need for any goods or services"?

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[34] (1977) 15 ALR 439.

The first step is to determine if the conduct proscribed in sections 997 and 1259, that is, the buying or selling securities or futures contracts constitutes a representation within the meaning of section 53(f). If it does, the next issue to be determined is whether such a representation is false. Prima facie, the buying or selling of securities or futures contracts is a normal business activity and is not a representation. However, if the transactions are orchestrated in such a way as to lead others to reasonably conclude that the prices of the securities or futures contracts are to rise or fall, the conduct could possibly amount to a representation under section 53(f) and since the prices are artificial, it may be contended that the representation is false. This point ie the falsity of the representation, is debatable as the prices, although artificial, are real prices actually traded in the market place.

As regards "corner" which is one of the mischiefs which sections 997 and 1259 seek to discourage, it is submitted that section 53 does not apply as the conduct in corners does not appear to involve any representation. The modus operandi for corners would entail purchasing more than the available supply of the securities or futures contracts and although it may push up prices, the act of purchase would not be a representation.

On the basis of the analysis, section 53 would not be an appropriate substitute for sections 997 and 1259.

A.4.2 Section 53 TPA vis a vis section 998 and section 1260 of the Corporations Law (false or misleading appearance of active trading)

To recapitulate, subsections 998(1) and 1260(1) prohibit a person from the creating a false or misleading appearance of active trading in any securities or futures contracts on organised markets or with respect to the price of any securities or futures contracts and subsections 998(3) and 1260(2) forbid the use of fictitious or artificial transactions or devices to maintain, inflate, depress, or cause fluctuations in, the price for dealings in securities or futures contracts.

Section 53(f) TPA would have the potential of being used against offenders who are in breach of sections 998 and 1260 if the acts prohibited in those provisions constitute a "false representation" under section 53 TPA. The issue which needs to be determined is whether creating a false or misleading appearance of active trading in securities or futures contracts could be a representation and second, whether such a representation is false. As discussed in the preceding paragraph A.4.1 the action of buying or selling, by itself, is not a representation. However, if the action is intended, as in sections 998 and 1260, to lead others to the conclusion that particular securities or futures contracts are actively traded, the view may be canvassed that it is implicit in that conduct, a

representation that there is a demand or need for the product when in fact there is not. Arguably, such a representation would be false in the sense that the demand is artificial as the activities in the markets are engineered by the manipulators, often without involving any change of beneficial ownership. This point is not free from doubt because although the active trading is contrived, the trading is nonetheless real.

The last point requiring analysis is whether the proscribed conduct is in relation to the supply of derivatives contracts or alternatively is in connection with the promotion of goods or services by any means. In relation to the issue of "supply", it is noted that the conduct proscribed in sections 998 and 1260 could be constituted either by selling in the market or buying from the market. However, because section 53 TPA is limited only to "supply", it would have no application to acts which comprise of purchases from the market. In relation to the alternative of "promotion of the supply or use of goods or services by any means" it needs to be determined, as a matter of fact, if the creation of a false or misleading appearance of active trading in securities or futures contracts is in connection with "promotion". This alternative would be relevant in a situation where the manipulator is in control of a huge supply of the target stock or futures contracts and attempts to create an active market to "promote" those stocks or futures contracts prior to disposing them on the market, hopefully at a profit. In view of the legal uncertainty as regards the interpretation of "false" in the context of the situations in section 998 or 1260 and given its limitation to situations where the misleading appearance is due to the manipulator selling (and therefore "supplying") securities or futures contracts to the market, it is unlikely to be employed as an alternative to sections 998 and 1260.

A.4.3 Section 53 TPA vis a vis section 999 and section 1261 of the Corporations Law (false or misleading statement in relation to securities or futures contracts)

The offences in sections 999 and 1261 comprise the making of a statement or disseminating information that is false or misleading in a material way and which is likely to induce the sale or purchase of securities or induce dealings in futures contracts if at the time of making the statement or disseminating the information, the person does not care if it is true or false or the person knows or ought reasonably to know that the statement is false. As seen in paragraph A.4, the making of a statement is a "representation." Given that an ingredient of the offence is that the statement must be false or misleading, the second requirement in section 53, which is that the representation must be false, is also satisfied. What needs to be determined is whether the misrepresentation is made in connection with the supply of derivatives contracts or alternatively is in connection with the promotion of derivatives contracts by any

means. The acts contemplated by sections 999 and 1261 of the Corporations Law need not involve any sale or purchase by the manipulator and section 53 TPA can be a viable alternative to those sections in the Corporations Law if and only if the manipulator is selling the securities or futures contracts. It is conceivable that the false statement be made in connection with a "promotion" of derivatives products and if that be so, it is section 53 TPA would be capable of acting as a substitute for sections 999 and 1261.

A.4.4 Section 53 TPA vis a vis section 1000 and section 1262 of the Corporations Law (fraudulently inducing person to deal in securities or futures contract)

The offences in sections 1000 and 1262 involves the dishonest concealment of material facts or the making or the publishing of any misleading, false or deceptive statement, promise or forecast. The dishonest concealment of material facts, it is submitted, would be a silent representation which would be false. Similarly, the making or the publishing of any misleading, false or deceptive statement, promise or forecast would be a misrepresentation in section 53. If such a false representation is made either in connection with a sale or a promotion of derivatives products, these offences would have the potential of being prohibited by section 53(aa), (e) or (f) depending on the circumstances surrounding the representation.

A.4.5 Section 53 TPA vis a vis section 1001 and section 1263 of the Corporations Law (dissemination of information about illegal transactions)

Sections 1001 and 1263 of the Corporations Law are enacted to control dissemination of information predicting movement of the prices of securities or futures contracts because of illegal market rigging activities. On the basis of the reasoning in paragraph A.4.4, it is contended that the conduct proscribed under sections 1001 and 1263 of the Corporations Law will not give rise to a cause of action under section 53 TPA unless the dissemination of information is on illegal activities which are not intended to be carried out, in which case, the dissemination of information would amount to a misrepresentation under section 53 TPA.

APPENDIX 2

GLOSSARY

ACCC
Australian Competition and Consumer Commission.

ACFSC
Australian Corporations and Financial Services Commission, the proposed new regulator for market integrity and consumer protection. It was originally known as Corporations and Financial Services Commission (CFSC) in the Wallis Final Report.

AFIC
Australian Financial Institutions Commission.

AFMA
The term stands for the Australian Financial Markets Association. It developed the AIRS terms and publishes a guide to using the ISDA Master Agreement under Australian Law which includes caps, collars, floors, FRA, forward rate bill agreements, swaptions, foreign exchange transactions and options, bond options, synthetic agreements for forward exchange and reciprocal purchase agreements.[1]

AIRS
This is the acronym for the Australian Interest Rate Swaps. The AIRS terms were used widely in Australia until 1990 and since then the ISDA terms are used and it is now the standard terms used in Australia.[2] The advantage of the AIRS terms is that they are simple and effective[3] but their use is limited in that they are structured for Australian Dollar denominated interest rate and for use between banks. If AIRS terms are used, they require significant amendments if a party to the contract is not a bank or a financial institution.

APRA
Australian Prudential Regulation Authority, the proposed new national prudential regulator. It was given the name of Australian Prudential Regulation Commission or APRC in the Wallis Final Report but was renamed by the Treasurer as the Australian Prudential Regulatory Authority.

ASC
The Australian Securities Commission, a body corporate established by section 8 of the *Australian Securities Act 1989* (Cth).

arbitrage
This is a technique used by a trader to make a profit trading in the same commodity (eg Australian currency) in two or more markets by taking advantage of the difference in prices in those markets

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[1] Mallesons Stephen Jacques, *Australian Financial Law,* 2nd ed. Business Law Education Centre, 1990, 383.
[2] Mallesons, note 1, 380.
[3] Mallesons, note 1, 382.

basket option
This is an option on a basket of securities, with the payout at maturity being based on a weighted average of the prices of the component securities rather than the price of one security. This option, if settled by cash, will be similar to an index option except that the amount payable if the option is in the money on the relevant exercise date is determined by the value of a pre-determined basket of shares, bonds or commodities rather than by reference to an index.[4]

Black-Scholes option pricing model
This is an option pricing model developed by Professors Fischer Black and Myron Scholes of the United States, and was regarded as a major breakthrough in the measurement of financial risks. The model provides a single formula which enables the fair price for a call option to be calculated.[5]

butterfly spread[6]
This is a spread position in options involving buying and selling options with three different strike prices for three consecutive delivery months in the same future.

call option
This term describes an option which gives the buyer of the option the right to buy from the seller of the option the asset or underlying referred to in the option at a predetermined price within a defined period or at a certain day.

caption
Caption is an option to enter into a cap agreement at a future date, with the terms of the agreement being agreed upon at the time of the purchase of the option.[7]

close out
The term refers to exiting from a contract, either by fulfilling the obligation in that contract or more commonly, by entering into a contract with opposite obligations so that the second contract cancels out the first.

commodity swap[8]
This refers to swapping a floating price for a fix price in respect of a particular commodity.

derivatives
A financial contract whose value is derived from the value of an underlying stock, bond, currency, index, reference rate, commodity or some other benchmark. Generally, derivatives fall into two categories: forward-type contracts and option-type

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[4] see Cresswell, et al., *Encyclopaedia of Banking Law Vol 2* (1982) Butterworths, England at F3437.4.
[5] Galitz, L, *Financial Engineering: Tools and Techniques to Manage Financial Risk*, Pitman Publishing, London, 1995, 214; Daugaard, D, & Valentino, T, *Financial Risk Management: A Practical Approach To Derivatives*, Harper Educational Publishers, 1995, 286
[6] Galitz, L, note 5, 270; Winstone, D, *Financial Derivatives: Hedging With Futures, Forwards, Options & Swaps*, Chapman & Hall, London, 1995, 283.
[7] Mallesons, note 1, 388.
[8] Daugaard, D, & Valentino, T, note 5, 217-219.

contracts. They may be listed on exchanges or traded privately (over-the-counter or OTC).

equity options[9]
They are options over stocks and shares. They may be call options or put options. Call options over shares were introduced in 1976 with the establishment of the Australian Options Market.

forward[10]
An OTC contract between two principals either to buy or to sell a particular commodity, currency or other financial instrument at a specified price on a fixed future date. Forwards are price-fixing contracts, because they saddle the buyer with the same returns as owning the underlying asset. Normally no money changes hands until the delivery date; then the contract is usually settled in cash rather than through exchange of the actual asset. Commercial banks, and institutional investors frequently use forward currency contracts to eliminate their exposure to fluctuating exchange rates in international investments, revenue flows and future liabilities.

Forward Rate Agreement (FRA)
This is an agreement between two parties on interest rates to be paid on a notional amount in a particular currency of specific maturity at a specific future time for a period of years. Although future contracts fulfil a similar function in providing a hedging mechanism to smooth out volatility in interest rate, they are mainly contracts with standardised size and settlement dates and are largely short term instruments.[11] These factors make them unsuitable to the needs of many corporations which require hedging to match their risk exposure usually for a term of years. In consequence, a custom built contract in the form of a forward rate agreement was developed to meet the needs of the business community.

A FRA is quoted with reference to two dates, the start date and the end date. These dates are quoted having regard to the month (notionally set at zero) in which the quotation is made. Thus a 'one-seven FRA' is an agreement to buy or sell a six-month bank bill in one month's time and a 'five-eight FRA' is an agreement to buy or sell a three months bill in five months time.

In the case of an importer who requires to borrow and who has opted to enter into a FRA, it has locked-in to an interest rate it can accept and thereby 'immune' itself from the fluctuations in interest rates. Whether the interest rate rises or falls, the importer can be rest assured that its profit margins will not be affected. However, in the case of a fall in interest rate, the importer would have forgone extra profits which it could have gained if it had not entered into the FRA.

Normally, no exchange on the principal sum is involved, and the difference between the contracted rate and the prevailing rate is settled in cash. Such an agreement

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[9] Carew, E, *Derivatives Decoded*, Allen & Unwin, Sydney, 1995, 126.
[10] McDougall, B, 'For the Younger Banker: Derivatives De-Mystified', the Australian Banker, Vol 108 No 2, 1994, 85.
[11] For a fuller discussion on the disadvantages of futures contracts, see Allan, R, et al., *Foreign Exchange Management*, Allen & Unwin, Sydney, 1990, 114.

creates an obligation to buy or sell a particular asset at an agreed price and on a particular date, with both price and date being fixed at the time of contract.[12]

fungible

This means interchangeable. All on exchange derivatives contracts have the characteristics of fungibility because the terms and conditions of one contract in a particular class are identical to those of any other contract in the same class and each contract is interchangeable with others within the same class.

futures contract[13]

A futures contract is a standardised agreement to deliver (sell) or accept delivery (buy) of an asset (commodity, financial instrument or others) at a definite price to be paid on a specified date in the future. It is an exchange-traded variety of a forward contract and has standardised contractual obligations. Both the buyer and seller are required to put up collateral, or margin, equal to a certain percentage of the contract's underlying value, which is marked to market daily.

globalisation

This is a term given to the integration of the capital markets of the world. So highly integrated are the markets that they are considered as one international capital market. This is evident from the absence of arbitrage opportunities in the world funds markets and from the tremendous growth in the volume of international transactions.

hedging

Hedging: is a strategy employed by a person to protect itself against movement of any of the variable factors in a commercial transaction such as interest rates (from their rise or fall), value of underlying asset (which can affect the cost or value of a transaction) or the investment value asset.

interest rate swap

This is an agreement between two parties under which each party agrees to make periodic payments to the other party in the same currency, the amount of the payments being determined by applying a rate of interest to a notional amount of such currency, each party's payment being calculated by reference to a floating rate such as the Singapore Interbank Offered Rate (SIBOR).[14]

in the money

This term is generally used with reference to options. When the prevailing market price is the higher than the strike price of the asset which is the subject of the option, that option is said to be 'in the money'.

ISC

Insurance and Superannuation Commission.

ISDA

ISDA is the acronym for the International Swap Dealers Association, Inc.

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[12] Mallesons, note 1, 384.
[13] McDougall, B., note 10.
[14] Cresswell, et al., note 4, F 3437.1.

Some of the standard forms published by ISDA are:[15]

(a) The 1992 ISDA multicurrency cross border master agreement, which is for all type of swap transactions, including currency swaps and cross border transactions and could be adapted for other derivative transactions.

(b) The 1992 ISDA local currency master agreement, which although similar to the multicurrency cross border master agreement, does not contain the currency conversion and cross border provisions.

(c) The 1991 ISDA definitions, which mainly concern calculations and provide the formulae which enable calculations to be made under the swap transactions

(d) The 1992 ISDA FX and currency option definitions

(e) The 1993 commodity derivative definitions, related to commodity based transactions

(f) User's guide to the 1992 ISDA master agreements, which provides a summary and explanation of various provisions in the forms.

mark to market[16]

This is the process of recalculating the exposure of a trader in a trading position or portfolio (of securities, equities or derivatives) on the basis of current market prices. By calculating the gains or losses on a futures contract using the closing prices at the end of the trading day, a clearing house would be in a position to determine the amount that needs to be deposited by the trader.

long position

A person holding a long position has more purchases in a commodity or currency than sales, giving that person a positive asset position in that commodity or currency.

netting[17]

Bilateral netting is an arrangement that allows amounts owing between two principals (trading with each other in more than one transaction) to be combined into a single net figure payable from one to another.. In the absence of a netting arrangement, a principal would need to treat each single contract with the same counterparty as a separate contract, without the right to set off credits against debits.

Netting by novation commonly refers to a master contract between two counterparties under which any obligation between the parties to deliver say a given currency on a given date is automatically amalgamated with all other obligations under the agreement for the same currency and value date. The result is to legally substitute a single net amount for the previous gross obligations.

Close out netting is an arrangement involving the use of a master agreement in which all contracts with a single counterparty, covering all maturity dates, are included. The market value of the portfolio can be calculated by evaluating the present value of positive and negative cash flows associated with all contracts and the net result becomes the amount which in the event of counterparty default, would be owed by

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[15] Mallesons, note 1, 382-383.

[16] McDougall, B., note 10.

[17] Gizycki, M & Gray, B, *Default Risk And Derivatives: An Empirical Analysis of Bilateral Netting,* Research Discussion Paper RDP 9409 Economic Research Department, Reserve Bank of Australia, December 1994.

one to the other. Such an arrangement would be capable of covering a wide range of contracts.

off-balance-sheet activities[18]

These are transactions which under accounting practices do not need to be booked in as assets or liabilities. Examples of such transactions include trading in swaps, options and futures and foreign-exchange forwards.

options[19]

An option is a contract in which the buyer pays a fee in exchange for the right, but not the obligation, to exchange a fixed amount of financial instrument for another (usually cash) at a prescribed price on or before a fixed future date. A call option gives the holder the right to buy while a put option gives the holder the right to sell the underlying asset. Options are price-insurance contracts because they protect buyers from adverse swings in the price of the underlying asset. The asset can never lose more than the price paid for the option, but the seller's losses are potentially unlimited.

An European Option is a contract which gives the purchaser, in consideration of an option fee, the right to buy or sell an asset at a specified price on a fixed date.

An American option is a contract which gives the purchaser, in consideration of an option fee, the right to buy or sell an asset on any date within the option period.

An option to buy is a call option while an option to sell is a put option.

option, exotic[20]

One of a wide variety of options with unusual underlying assets or peculiar terms or conditions. A lookback option, for example, confers the retroactive right to buy a given financial instrument at its minimum price, or sell it at its maximum price, during a specified lookback period. A compound option is an option such as a put on a call, a call on a put, a put on a put, or a call on a call.

OTC derivatives

These are derivatives contracts that are transacted over-the-counter and not on organised exchanges. Generally, there are two parties to the contract. Most of the derivatives sold by banks are OTC derivatives.

out of the money

This term is generally used with reference to options. When the prevailing market price is the lower than the strike (agreed) price of the share or other asset over which the option is granted, that option is said to be 'out of the money'.

RBA

Reserved Bank of Australia.

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[18]McDougall, B., note 10.
[19]McDougall, B., note 10.
[20]McDougall, B., note 10.

<u>rocket scientist</u>
One of Wall Street's brilliant inventor of new financial derivatives products, based on basic derivatives such as options, swaps, and futures.

<u>share ratio contracts</u>
These are a new form of derivatives products. They are contracts traded on the ASXD (ASX Derivatives) and measures the performance of a particular share against the All Ordinaries Index. Thus, the share ratio is expected to increase if the price of that share rises by more than the market or alternatively falls by less than the market. Share ratio contracts provide investors with the opportunity of betting on specific shares which they believe will outperform the general market.

The ASX share ratio market which was announced in August 1994[21] was officially opened on 14 July 1995. Share ratio contracts are governed by the Corporations Law, which was amended by the *Corporations Law (Securities and Futures) Amendment Act 1995* (sometimes referred to as "the Share Ratio Act") to enable a regulatory regime to be constructed for this hybrid product. The regime is provided by regulations which became effective on 6 July 1995. As share ratio is in essence a hybrid of a futures contract and securities, it is subject to

a. Chapter 7 (except for section 775 - power of ASC to prohibit trading in particular securities, section 842 - issue of contract notes, section 843 - dealings and transactions on a dealer's own account, section 844, section 844 - dealer to give priority to clients' orders, part 7.4 Division 2 - short listing of securities, part 7.12 - offering securities for subscription or purchase, part 7.13 - title and transfer of securities);
b Part 8.3 (licensing of futures brokers and advisers - applied as if securities dealers were futures brokers);
c Section 1137 and 1138 (duty of futures exchange to maintain an orderly market - applied as if ASX were a futures market);
d section 1205 (undesirable advertising);
e section 1206 (issue of contract notes);
f section 1207 (monthly statements to clients)
g section 1208 (dealings by futures broker on own account);
h section 1210 (duty of futures brokers to explain futures to clients);
i Part 8.7 (futures offences), except section 1258 - dealings only on futures markets and section 1267 - dealings by futures employees and advisers.

The schedule of applied provisions is contained in Part 1.2 of the Corporations Regulations.

Share ratios are calculated as follows:

$$\frac{\text{Share price in cents}}{\text{All Ordinaries Index}} \times 1{,}000$$

Trading is on Stock Exchange Automated Trading System or SEATS, the screen based automatic trading system and contracts are cleared through the Options Clearing House, which is the clearing system for ASX derivatives.

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[21] Carew, E, note 9, 133.

short position
A person is said to hold a short position if that person has more sales contracts than boughts contracts. This is the opposite of a long position.

spot
Spot trading refers to "on the spot" or today's trading.

strike price[22]
This refers to the price of the underlying asset at which an option may be exercised. For that reason, it is sometimes known as exercise price.

swap[23]
A swap is a forward-type contract which involves the exchange of one type of cash flow, or asset, for another, according to predetermined terms. For example, an interest-rate swap is a contract between two counterparties to exchange over a certain period fixed-interest payments for floating-interest payments on the same notional principal. An equity-index swap may involve swapping the returns on two different stock-market indexes or swapping the return on a stock index for a floating interest rate.

swap (interest rate)
An interest rate swap has been judicially explained as "an agreement between two parties by which each agrees to pay the other on a specified date or dates an amount calculated by reference to the interest which would have accrued over a given period on the same notional principal sum assuming different rates of interest are payable in each case. For example, one rate may be fixed at 10 per cent, and the other rate may be equivalent to the six-month London Interbank Offer Rate ('LIBOR'). If the LIBOR rate over the period of the swap is higher than 10 per cent, then the party agreeing to receive 'interest' in accordance with LIBOR will receive more than the party entitled to receive the 10 per cent. Normally neither party will in fact pay the sums which it has agreed to pay over the period of the swap but instead will make a settlement on a 'net payment basis' under which the party owing the greater amount on any day simply pay the difference between the two amounts due to the other."[24]

swap documentation
There are 3 main forms of agreement being used in Australia. These are (1) the IDSA Master Agreement (2) individual master agreement and (3) customised agreements for particular transactions.

swap foreign exchange rate contract[25]
This is a combination of two transactions:
(a) a spot transaction; and
(b) a forwards transaction.

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[22] Carew, E, note 9, 49.
[23] McDougall, B., note 10.
[24] *Hazell v Hammersmith and Fulham London Borough Council and Others* 1990 2 WLR 17, 52.
[25] Allan, R, note 11, 11.

To effect a swap of one currency for another, a participant could sell its existing currency on the spot market in exchange for the wanted currency. Simultaneously, it enters into a forward contract to buy back its original currency. This mechanism may be used by a person wishing to take advantage of a higher interest overseas by converting its original currency to the high interest yielding currency and at the same time protecting the value of its original currency by buying back that currency on the forward market.

swaption[26]
This is an option to enter into a swap agreement (the terms of such agreement being agreed upon at the time of the option) at a future date.[27] For example, a simple interest-rate swaption is essentially an option to exchange a fixed-rate bond for a floating-rate bond.

systemic risk
This risk has been defined as "the risk that a disruption (at a firm, in a market segment, to a settlement system, etc.) causes widespread difficulties at other firms, in other market segments or in the financial system as a whole"[28]

value-at-risk (VAR)
This is a conceptual framework which incorporates a scientifically based method of calculating risk. VAR is a statistical estimate, for a level of probability of how many units of one type of currency a participant risks losing over a specified period of time due to changes in the market place. It is intended primarily to calculate market price although it has the potential to be used also for measuring liquidity and operational risks.[29]

volatility
Volatility is the measure of an asset's potential for deviating from its current price.[30] The term has also been defined to mean "erratic, mercurial change".[31]

warrant
A warrant[32] is a form of long dated call or put option used in relation to stocks and shares. It is not a defined term in the Corporations Law. A call warrant gives the holder of the warrant a right, but not an obligation, to purchase a number of shares from the issuer of the warrant at a specified price and by a specified date. Call warrants are issued by third parties approved by the ASX, currently restricted to

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[26] McDougall, B., note 10.
[27] Mallesons, note 1, 389.
[28] This quotation was attributed to the report of the Bank for International Settlement, *Recent Developments in Interbank Relations,* Report prepared by a Working Group established by the Central Banks of the Group of Ten countries, Basle, October 1992 cited in Group of Thirty, Global Derivatives Study Group, 'Derivatives: Practices and Principles', Washington, 1993, 61 and 127.
[29] 'VAR: Pushing Risk Management to the Statistical Limit' (undated). The article is available on the internet at http://www.cats.com/cats/varart.shtml
[30] Winstone, D, note 6, 242.
[31] Carew, E, note 9, 53.
[32] see Tribe, D, "Warrants replace futures as flavour of the month on ASX", The Sydney Morning Herald, 28 February 1996; Kavanagh, J, "Warrants offer arresting option", The Weekend Australian, 30-31 March 1996, 13; Wasiliev, J, "Warrants a Punt", the Financial Review, 2 November 1995, 8.

mainly licensed banks, governments and institutions which are guaranteed by banks or by governments.[33] Macquarie Bank was the first to issue call warrants. In January 1991, it launched a series of 15 million call warrants over shares in Boral Limited and a year later, it made a second issue of 10 million call warrants over BHP shares.[34] The first index warrants were issued by Bankers Trust Australia Ltd which wrote 4 million call warrants over the All-Ordinaries Index in 1991.[35] These issuers are responsible for settlement at the time the warrants are exercised.

[33] Carew, E, note 9, 132.
[34] see Carew, E, note 9, 132.
[35] see Carew, E, note 9, 132.

APPENDIX 3

RECOMMENDATIONS OF THE WALLIS COMMISSION AND PROPOSALS OF THE TREASURY FOR REFORM OF REGULATION ON FINANCIAL MARKETS AND INVESTMENT PRODUCTS

Introduction

Given the importance of the recommendations in the Financial System Inquiry Final Report[1] (Wallis Final Report) and the recent proposals of the Treasury[2] (Position Paper), selected recommendations of the Wallis Final Report and the proposals in the Position Paper are set out in this Appendix for ease of reference.

Wallis recommendations

The following are the Wallis Committee recommendations which are referred to in the text of this thesis or in the Treasury's position paper entitled 'Financial Markets and Investment Products' released on 20 December 1997.

Recommendation 1: Corporations Law, market integrity and consumer protection should he combined in a single agency.

A single agency, the Corporations and Financial Services Commission (CFSC), should be established to provide Commonwealth regulation of corporations, financial market integrity and consumer protection. It should combine the existing market integrity, corporations and consumer protection roles of the Australian Securities Commission (ASC), the Insurance and Superannuation Commission (ISC) and the Australian Payments System Council.

Recommendation 2: The CFSC should have comprehensive responsibilities.

The CFSC should be responsible for:

- financial market integrity, including:
  - regulating disclosure for securities and retail investment products;
  - regulating market conduct to promote orderly and efficient price discovery, trading and settlement;
  - determining applications for new exchanges, and overseeing the activities of existing exchanges;
  - regulating investment and insurance sales and advice financial market dealers and participants;
  - regulating compliance of collective investment schemes;
  - facilitating the development of new markets for debt and equity instruments;

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[1] Financial System Inquiry, *Financial System Inquiry Final Report,* Australian Government Publishing Service, March 1997 (Wallis Final Report).

[2] Commonwealth of Australia, *Financial Markets and Investment Products,* Corporate Law Economic Reform Program Proposals for Reform: Paper No 6, AGPS, 1997 (Position Paper).

  - monitoring financial innovation and technological developments in the provision of financial products and services and determining appropriate regulatory responses;
- regulation of corporations, including incorporation, governance, insolvency and liquidation, and takeovers; and
- financial sector consumer protection regulation, including:
  - regulating the conduct of dealings with consumers and the prevention of fraud;
  - approving and overseeing industry codes of conduct, codes of conduct for new payments technologies and dispute resolution arrangements;
  - delegating accreditation and disciplinary functions self-regulatory bodies where appropriate; and
  - setting benchmarks for and monitoring the performance of those self-regulatory bodies.

Recommendation 3: The CFSC should administer all consumer protection laws for financial services.

While the economy wide reach of the powers of the Australian Competition and Consumer Commission (ACCC) should be retained in law (subject to Recommendation 4), the CFSC should have sole responsibility for administering consumer protection regulation within its jurisdiction over the finance sector. For this purpose, consumer protection provisions comparable to those in the *Trade Practices Act 1974* should be included in the CFSC's legislation.

Recommendation 5: The CFSC and ACCC should coordinate examination of financial exchange rules.

To improve the administration of the law relating to the rules of financial exchanges:

- financial exchange business and listing rules should be subject to disallowance on market integrity grounds by the CFSC rather than the Treasurer;
- the ACCC should continue to be responsible for authorising financial exchange rules and arrangements under s. 88 of the *Trade Practices Act 1974*; and
- the CFSC and ACCC should coordinate and accelerate their consideration of these rules.

Recommendation 7: The CFSC should have powers to use a combination of regulatory approaches.

In addition to its framework legislation, the CFSC should have powers to adopt detailed codes which prescribe appropriate conduct and disclosure in particular industries or to allow the industry to develop such codes. Given these broad powers, the CFSC would have the discretion to decide the best approach to regulation to be used in particular circumstances.

The CFSC should have an explicit mandate to balance the efficiency and effectiveness of its regulatory approaches.

Recommendation 8: Disclosure requirements should be consistent and comparable.

Disclosure requirements for retail financial products (deposit accounts, payments instruments, securities, collective investments, superannuation and insurance products)

should be reviewed by the CFSC to ensure they provide information that enables comparison between products. This information should:

- be comprehensible and sufficient to enable a consumer to make an informed decision relating to the financial product;
- be consistent with that for similar products regardless of which institution offers them; and
- appropriately disclose remuneration or commissions paid to advisers.

The disclosure codes of conduct applying to banking, building societies and credit unions should be made consistent wherever possible.

The effectiveness of disclosure requirements should be monitored regularly using complaints date and user testing.

Recommendation 9: Profile statements should he introduced for more effective disclosure.

The law should be amended to require the issue of succinct profile statements about offers of retail financial products, including initial public offerings. These statements must contain:

- a brief description of the characteristics of the product;
- a clear and unambiguous statement of the risks involved;
- a clear and unambiguous statement of applicable fees, commissions and charges in a form which enables comparison with similar products; and
- such other disclosures for specific products as the regulator considers appropriate.

Beyond this, the contents of a profile statement should not be prescribed by regulation, except in cases where the CFSC believes that prescription is required to provide balanced representation of the product. The format should be developed by the CFSC in consultation with industry groups.

Recommendation 13: A single licensing regime should be introduced for financial sales, advice and dealing.

The CFSC should establish a single regime to license advisers providing investment advice and dealing in financial markets. There should be separate categories of licence for investment advice and product sales, general insurance brokers, financial market dealers, and financial market participants.

Recommendation 14: The CFSC should have power to delegate accreditation responsibilities to industry bodies.

The CFSC should have power to devolve responsibility for competency training and to industry bodies. It should also have the option to require that licence holders be members of codes of conduct or dispute schemes that meet minimum standards.

Recommendation 15: A single set of requirements should be introduced for financial sales and advice.

The CFSC should develop a single set of requirements for investment sales and advice including:

- minimum standards of competency and ethical behaviour;
- requirements for the disclosure of fees and adviser's capacity;
- rules on handling client property and money;

- financial resources or insurance available in cases of fraud or incompetence; and
- responsibilities for agents and employees.

Recommendation 17: Licensing of professionals providing incidental financial advice is generally not required.
Professional advisers such as lawyers and accountants, should not be required to hold a financial advisory licence if they provide investment advice only incidentally to their other business and rebate any commissions to clients.

Recommendation 18: Additional prudential regulation of financial market licence holders is not required.
It is not necessary at this time to impose additional prudential regulation, capital or risk management requirements on financial market licence holders aimed at minimising contagion or systemic risk in the event of failure. However, this situation should be kept under review by the CFSC in conjunction with the prudential and systemic stability regulator.

Recommendation 19: Broader regulation of 'financial products' should replace current securities and futures law.
The law covering financial markets should adopt a broad definition of 'financial products' subject to generic requirements and supplemented by specific regulation for particular classes of products. This should replace existing separate Corporations Law regulation of securities and futures contracts. The CFSC should have the flexibility to declare certain products to be covered by, or to be exempt from, the law.

An effect of such a generic definition would be that the Australian Stock Exchange could deal in futures products and the Sydney Futures Exchange could deal in corporate securities (see Recommendation 21).

Recommendation 20: Prohibitions on retail participation in over-the-counter derivatives markets should be discontinued.
The existing prohibitions on retail participation in over-the-counter (OTC) derivatives markets should be discontinued. The law should provide an additional layer of consumer protection for retail transactions compared with purely wholesale markets or transactions.

Recommendation 21: The CFSC should authorise financial exchanges under a single regime.
The CFSC should be empowered to grant authorisation to operate a financial market to any corporation meeting objective criteria aimed at ensuring that it will operate a fair and efficient market. There should be a single authorisation procedure for financial exchanges. The conditions attaching to authorisation will depend on the nature of the market authorised.

Recommendation 22: Regulation of exchanges should not be excessive compared with OTC markets.
The CFSC's charter should include a responsibility to ensure that the regulation of exchanges is not excessive compared with OTC markets. Market forces, rather than legislation, should determine whether transaction is conducted on exchange or in an OTC market.

Recommendation 23: OTC markets may be conducted by appropriately licensed intermediaries.

The CFSC should have power to authorise a financial market dealer to operate an OTC market, subject to any conditions necessary to ensure that the market is conducted fairly and that operational risks are contained. There should be no separate authorisation of exempt markets.

Recommendation 24: Exchange clearing houses should be appropriately authorised.

The CFSC should consider the appropriateness of proposed clearing and settlement arrangements as part of its oversight of financial exchanges and should be responsible for authorising financial exchange clearing houses.

Recommendation 25: A central gateway for dispute resolution should be established.

The CFSC should 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.

Recommendation 27: The CFSC should have broad enforcement powers.

The CFSC should be provided with adequate enforcement powers including:

- appropriate regulatory and investigative powers, including powers to obtain documents and question persons involved in the relevant conduct and to accept legally enforceable undertakings;
- provision for protection from liability for those who provide investigative assistance;
- power to impose administrative sanctions, such as banning or disqualification orders; and
- power to initiate civil actions, to seek:
  - punitive court orders such as financial penalties;
  - a range of remedial court orders, including restitution orders, injunctions and corrective advertising orders; and
- power to initiate, and to refer matters to the Director of Public Prosecutions for criminal prosecution.

Recommendation 30: Prudential regulation should be imposed on deposit taking, insurance and superannuation.

Prudential regulation should be imposed on institutions licensed to conduct the general business of deposit taking from the public, or offering capital backed life products, general insurance products or superannuation investments.

Recommendation 31: A single Commonwealth prudential regulator should be established.

A single Commonwealth agency, the Australian Prudential Regulation Commission (APRC), should be established to carry out prudential regulation in the financial system.

Recommendation 57: The CFSC should be responsible for regulation of financial exchanges

The CFSC should be responsible for regulation of financial exchanges and keep the adequacy of exchanges' risk controls under review.

Financial exchanges should be included among those institutions and regulatory agencies for which there should be legislative change to remove any impediments to voluntary information sharing.

Recommendation 58: Regulatory agencies should monitor wholesale markets.

The regulatory agencies should monitor the evolution of wholesale markets for the emergence of large institutions not subject to regulation domestically or overseas by a prudential regulator. In case of an identified need, the APRC should recommend an increase in regulatory coverage.

Recommendation 59: The RBA should promote control of domestic and international settlement risks.

The RBA should give high priority to promoting cost-effective control of domestic and international settlement risks, including by benchmarking exercises to improve systems within institutions involved in wholesale international payments, encouraging payments netting arrangements, shortening settlement times for clearing systems and extending settlement hours to allow coordinated delivery versus payment and payment versus payment arrangements.

The legislative program should expedite preparation and consideration of:

- legislative amendments for information sharing between domestic and relevant overseas regulatory agencies;
- netting legislation to cover failure to settle by participants in the payment system; and
- legislation to give legal certainty to bilateral netting of financial transactions as proposed by the Companies and Securities Advisory Committee Netting Sub-Committee - these amendments are to put beyond doubt the legal enforceability of netting contracts under the *Banking Act 1959*, the *Life Insurance Act 1995* and other legislation in the event of insolvency, liquidation, bankruptcy, receivership and voluntary administration.

Recommendation 80: The ACCC should administer competition laws for the financial system.

The ACCC should continue to administer competition laws for the financial system as for other sectors.

Recommendation 89: Regulation of collective investments and public offer superannuation should be harmonised.

The regulatory framework for public offer collective investments and superannuation should be harmonised to the greatest possible extent by:

- making both types of products subject to a single consumer protection regime (including disclosure rules) administered by CFSC; and

- bringing the structure of collective investments into line with that for superannuation funds, by introducing a requirement for a single responsibility entity.

Recommendation 109: Regulatory agencies should improve their reporting.
To ensure adequate accountability and to assist the application of efficient cost-recovery arrangements, each regulatory agency should develop internal accounting systems and reporting arrangements to identify its effectiveness and efficiency, both in aggregate and in respect of each major regulatory objective.

Each agency should report annually to Parliament and should seek continuous improvement in reporting quality. Reports should include the results of internal assessments of efficiency, compliance costs and cost effectiveness. Where possible, comparisons with international best practice should be provided.

Position Paper

The Treasury made the following nine proposals in its Position Paper:[3]

Proposal No 1 - Uniform regulation of financial instruments
A more efficient and flexible regime for financial markets and investment products will be achieved by developing an integrated regulatory framework for financial instruments. The new regulatory regime will provide consistent regulation of functionally similar markets and products.

Financial instruments will include all securities, futures and other derivatives as well as foreign exchange, superannuation, general and life insurance and deposit accounts (see Appendix C).

The existing diverse regulatory arrangements for financial markets and investment products under the Corporations Law, the Insurance (Agents and Brokers) Act, the Insurance Contracts Act, the Banking Act, the Superannuation Industry (Supervision) Act and various industry codes will be harmonised.

Proposal No 2 - New regulatory framework
Persons will be prohibited from conducting a market in financial instruments or providing financial intermediary services unless they hold an appropriately endorsed financial markets licence. The financial markets licence will have three categories:

- a licence to operate a market facility;
- a licence to operate a clearing and settlement facility; and
- a licence to provide financial intermediary services.

The criteria to be satisfied in order to obtain a licence will be broadly stated and flexible to accommodate different market structures, investment products and financial intermediary services. The way in which these legislative requirements will be satisfied will vary according to the nature of the services provided.

[3] Some of the proposals have been paraphrased.

Proposal No 3 - Market facilities

A licence to operate a market will be required if a person proposes to provide a market facility:

- where financial instruments are regularly traded or information is provided about the prices at which a person may be expected to trade financial instruments; and
- which involves multiple buyers and sellers.

The criteria to be satisfied to obtain a licence to conduct a market facility will be that the market operator must:

- have adequate arrangements for the supervision of the market;
- have and maintain sufficient resources to conduct the market and carry out supervisory functions;
- have adequate rules or procedures for the operation of the market, including access to market facilities, the recording and disclosure of transactions effected on the market and procedures for dealing with complaints;
- have adequate arrangements for the clearing and settlement of transactions; and
- have adequate protection for retail investors.

The legislation will set out the ongoing obligations which will be imposed on a market operator to ensure that the objectives of market regulation are satisfied on a continuing basis.

Proposal No 4 - Clearing and settlement facilities

The fourth proposal is aimed at those who conduct a clearing and settlement facility to ensure that those who operate such facilities meet the criteria set out in the legislation.[4] It is proposed that those who operate a clearing and settlement facility as a stand alone operation and not part of the activities of a market operator will need to obtain a licence. The licence will only be granted if the facility provider have adequate rules and procedures for the operation of the facility, arrangements for the supervision of the facility and maintain sufficient resources to conduct the facility and perform supervisory functions.

On-going obligations will be imposed on providers to ensure that the objectives of market regulation are complied with.

Proposal No 5

In line with Recommendation 13 of the Companies and Securities Advisory Committee's 'Regulation of On-exchange and OTC Derivatives Markets, Final Report' published in June 1997, the Treasury has proposed a single licensing regime for financial market dealers and advisers.

The criteria to be satisfied to obtain a financial intermediary's licence will be that the intermediary must:

- have adequate financial resources for the performance of the proposed activities; and
- have the competence, skills and experience to provide the relevant services.

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[4] Position Paper, note 2, 3.

Conditions will be imposed on a financial intermediary's licence to ensure that the objectives of market regulation are satisfied on a continuing basis.

Proposal No 6 - Conduct of financial intermediary's business
Statutory obligations will be imposed on intermediaries in relation to their dealings with retail investors including requirements relating to:

- risk disclosure;
- confirmation documentation and periodic statements;
- accounts and record keeping;
- benefits disclosure;
- pressure sales;
- the suitability of personal product recommendations; and
- complaints and dispute resolution.

Proposal No 7 - Disclosure
It is highly desirable that a consistent and comparable disclosure regime for all financial instruments be developed. The Government seeks comments on the proposed formulation of the disclosed standards including how a regime may be developed to assist investors to make comparisons across all financial instruments.

All financial instruments, other than securities which are subject to the prospectus provisions, will be subject to a requirement to disclose all relevant information to permit investors to make informed investment decisions. The disclosure document must address specific issues in order to increase comparability across similar investment products. Promoters or issuers of financial products will be required to disclose to investors the fundamental terms and obligations attaching to a financial products as well as the risks involved with the product and all fees, commissions and charges.

The fundraising provisions will apply to specified financial instruments (shares, debentures, managed investments). The development of profile statements under the Corporations Law will assists investors to compare securities and other financial instruments.

Proposal No 8 - Market misconduct
The market misconduct provisions of the Corporations Law, which include insider trading and market manipulation will be harmonised for all markets where financial instruments are regularly traded by multiple buyers and sellers.

Rules relating to misconduct by financial advisers and dealers, including breaches of licence conditions, will be harmonised and enforced by ACFSC.

Proposal No 9 - Regulatory responsibility
The proposed implementation of the reforms to the regulation of financial markets and investment products will result in a new approach to the regulation of financial market participants. The Government seeks comments on the appropriate mechanism for responsibility for the new regulatory regime.

One option would be to retain the current division of responsibility for regulating markets and intermediaries as adopted by the Corporations Law. The Treasurer

would be responsible for licensing markets, clearing and settlement facilities and considering amendments to market rules. The Australian Corporations and Financial Services Commission (ACFSC) would administer the licensing regime for financial advisers and dealers. If the Treasurer is of the opinion that a market is not complying with its ongoing obligations, the Treasurer may publish a notice in the Gazette directing the market to do specified things that the Treasurer believes will promote compliance by the market with those requirements.

An alternative approach would be to provide the ACFSC with responsibility for the day to day administration of the new regulatory regime. The ACFSC would be responsible for all aspects of the single licensing regime, including licensing markets, clearing and settlement facilities and financial advisers and dealers. The ACFSC would oversee the product disclosure requirements for all financial instruments and have broad enforcement powers relating to financial markets and investment products.

Given the economic significance of markets and investment products, the Treasurer would oversee the performance of the ACFSC through the following mechanism:

- the Treasurer may give directions to the ACFSC about the priorities and policies it must pursue in carrying out its functions;
- the ACFSC must report annually to the Treasurer on the exercise of its discretions, including the number of applications for licences and the numbers granted and refused;
- the ACFSC must immediately notify the Treasurer of any matters which would have significant ramifications for the regulation of the financial system; and
- the Treasurer may ask the ACFSC to provide a special report on the performance of its functions and the exercise of its powers in relation to financial markets.

If the Treasurer is of the opinion that a market is not complying with its ongoing obligations, the Treasurer may publish a notice in the Gazette directing the market to do specified things that the Treasurer believes will promote compliance by the market with those requirements.

Accountability of the ACFSC would also be provided through:

- subject decisions to a right of review;
- clarifying the charter of the regulatory - eg, the ACFSC must facilitate competition and financial innovation, and the development of a new markets while maintaining market integrity and investor confidence; and
- utilising the Financial Sector Advisory Council to gain feedback from the business community on the operation of the new regime.

APPENDIX 4

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