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The Parliament of the Commonwealth of Australia

REPORT ON DERIVATIVES

PARLIAMENTARY JOINT COMMITTEE ON
CORPORATIONS AND SECURITIES

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PARLIAMENTARY JOINT COMMITTEE ON CORPORATIONS AND SECURITIES

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DUTIES OF THE COMMITTEE

Section 243 of the *Australian Securities Commission Act 1989* reads as follows:

The Parliamentary Committee's duties are:

(a) to inquire into, and report to both Houses on:

(i) activities of the Commission or the Panel, or matters connected with such activities, to which, in the Parliamentary Committee's opinion, the Parliament's attention should be directed; or

(ii) the operation of any national scheme law, or of any other law of the Commonwealth, of a State or Territory or of a foreign country that appears to the Parliamentary Committee to affect significantly the operation of a national scheme law;

(b) to examine each annual report that is prepared by a body established by this Act and of which a copy has been laid before a House, and to report to both Houses on matters that appear in, or arise out of, that annual report and to which, in the Parliamentary Committee's opinion, the Parliament's attention should be directed; and

(c) to inquire into any question in connection with its duties that is referred to it by a House, and to report to that House on that question.

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1. INTRODUCTION

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

Background to the Committee's Report

1.1 On 18 November 1994 members of the Parliamentary Joint Committee on Corporations and Securities visited the Sydney Futures Exchange to observe its operations and meet informally with executives of the Exchange. The Committee subsequently decided, pursuant to its power to inquire into the operation of the national scheme laws, to conduct a public hearing with the Sydney Futures Exchange to discuss issues relating to the regulation of derivatives markets. Shortly before that hearing Barings Bank crashed as a result of massive losses incurred by its Singapore branch in derivatives trading.

1.2 This incident gave additional and sharper focus to the Committee's hearing. The Committee decided that it should also hold public hearings on derivatives with the Australian Stock Exchange, the Australian Securities Commission and the Corporations and Securities Advisory Committee to discuss both general issues relating to the regulation of derivatives trading and specific issues arising from the Barings crash.

Derivatives

1.3 Derivatives are financial products which derive changes in their value from the price of an underlying commodity, security, currency, cash flow or index. The main types of derivatives are futures[2], options[3] and swaps[4],

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

2 Futures and forward rate agreements involve an agreement to buy or sell an asset at a given price on a future date.

3 Options contract give one party the right (but not the obligation) to buy or sell an asset in the future.

although the range of derivatives products is continually expanding and many derivatives contracts combine features of more than one type.

1.4 Derivatives can be divided into two categories depending on how they are traded. Exchange traded derivatives are standard products traded on exchanges. These transactions are subject to rules of the exchange and securities legislation. Over the counter (OTC) derivatives are not traded on exchanges and are usually tailored for a client by a financial institution. A survey by the Australian Financial Markets Association last year found that the levels of business transacted on exchange and off exchange were approximately equal. The amount of business traded on the Sydney Futures Exchange and in over counter transactions was approximately $1 trillion per annum in each market.[5]

1.5 Derivatives are used as a method of risk management, to rapidly adjust the balance of an investment portfolio, or for speculation. The transaction costs and margins required when an individual enters into a derivatives contract are a small proportion of the face value of the contract.

1.6 When derivatives are used for hedging they can be a valuable risk management tool. They allow businesses to buffer themselves against adverse movements in a market and to plan future activity with greater certainty.

1.7 However, speculative trading in derivatives carries with it the potential for both very large profits and losses. A significant movement in the market can lead to profits or losses much larger than the initial outlay. Speculation in derivatives has resulted in serious losses for some businesses. However, Arthur Levitt, Chairman of the United States Securities and Exchange Commission, recently commented in a speech to mutual fund managers and directors:

> *As I've said on numerous occasions, it would be a grave error to demonize derivatives and blame them for these losses. Derivatives are not inherently good or bad -- they're something like electricity: dangerous if mishandled, but bearing the potential to do good. What these spectacular losses highlight for me is the importance of proper oversight and supervision. The best defence any system of investment can have against major loss is an effective risk management system and stringent internal control mechanisms.*[6]

4 Swaps involve an interest rate or currency exchange. In the case of an interest rate swap one party is obliged to pay a fixed interest rate to the other party in return for a floating interest rate.

5 Hosking, Committee Hansard, Sydney Futures Exchange, 6 March 1989, p. 39.

Major Derivatives Losses

1.8 The world's derivatives markets have emerged from relative obscurity only in recent decades. The volume of trade, and the number of products available, has grown very rapidly. Derivatives now occupy an important place in the world's financial system. In parallel with the growth of derivatives markets there has been a string of major losses involving derivatives around the world in recent years:

- Odessa College - $US11 million on mortgage based derivatives.
- AWA - $A50 million on foreign exchange dealings.
- Nippon Steel - $US130 million on foreign exchange derivatives.
- Procter and Gamble - $US157 million on interest rates swaps.
- Royal Dutch Shell/ Showa Shell - $US1 billion on forward rate agreements.
- Metallgesellschaft - $US1.5 billion on oil futures and options.
- Orange County - $US1.7 billion on interest rates.
- Barings - £860 million on stock and bond futures.

1.9 The most recent derivatives crash involved Barings. Barings was Britain's oldest, and one of its most prestigious, merchant banks. In late February 1995 the bank crashed as a result of massive losses (£860 million - $A1.73 billion) suffered by its Singapore branch. The losses arose from speculative trading in Nikkei 225 index[7] contracts on the Singapore International Money Exchange and the Osaka Stock Exchange by one of Barings traders, Mr Nick Leeson. Mr Leeson began by arbitraging[8] then decided go long[9] on the Nikkei 225 index. When the Nikkei 225 index fell sharply Barings suffered heavy losses. The losses exceeded the banks capital and it was subsequently sold out of receivership to the Dutch ING Bank.

6 Arthur Levitt, Chairman of the United States Securities and Exchange Commission, *"Mutual Fund Directors As Investor Advocates"*, Speech given to The Second Annual Symposium For Mutual Fund Trustees And Directors, Washington D.C., April 11, 1995.

7 The Nikkei 225 index is an index of the top 225 stocks listed on the Tokyo Stock Exchange.

8 An arbitrage is the simultaneous purchase and sale of the sale financial instruments on two different exchanges with the objective of making a profit from the difference in prices on the two exchanges.

9 A long position is one where the trader has brought more of a security than they have sold. If the price of the security rises they will make a profit.

1.10 At the time of the Committee's hearings investigations into the collapse were still at a very early stage. Much of the discussion before the Committee was therefore based on media reports. However, witnesses before the Committee identified the following factors as important in the Barings collapse:

- poor trading decisions by Mr Leeson who invested heavily in long positions on the Nikkei 225 index;
- concealment of his trading position by Mr Leeson;
- the lack of any separation of functions in Baring's Singapore office. Mr Leeson was both the trader and operated all of the back office accounting procedures;
- lack of management control by Barings;
- an unusual shift in the market which saw the Nikkei fall away very rapidly;
- the Singapore financial market structure involves a lot of branch office activity and representative office activity which allows two or three people to run very large trading books;
- lack of attention paid by the marketplace to Barings' activity in Singapore;
- the level of supervision on the Singapore exchange was lower at some other exchanges;
- the Singapore exchange was not as assertive as it might have been in following up its inquiries;
- the lack of any exchange of information between the Singapore and Osaka exchanges which may have revealed Mr Lesson's and Baring's true position;
- the lack of communication between exchanges.

2. Evidence Given at the Committee's Hearings

Sydney Futures Exchange

2.1 The Committee conducted a public hearing with the Sydney Futures Exchange in Canberra on 6 March 1995.

2.2 In response to questions from the Committee about the possibility of a derivatives crash like Barings occurring in Australia, Mr Hosking from the Sydney Futures Exchange outlined the Exchange's procedures and the safeguards it has in place.

> *First of all, I think it might be worthwhile to just describe what we believe to be the weaknesses that were in the Singapore incident. Barings allowed a 28-year-old trader to have full run of the office in Singapore. He was the trader, he operated all the back office accounting procedures, he paid the cheques and he was fully accountable for all sectors of the business.*
>
> *In Australia, the Sydney Futures Exchange does not permit its members to have only one management function amongst the entire organisation. We do require our members to have separation of trading activity from back office accounting activity and, indeed, from senior management. We do ensure that those three levels have different contact from the Sydney Futures Exchange.*
>
> *Secondly, I think the Singapore financial market structure is quite different to Sydney's, in that there is a lot of branch office activity and representative office activity which does allow for only two or three people in the office to run very large trading books and be accountable to their head office. Our membership structure and our membership requirements require a more substantial commitment to the Sydney Futures Exchange in our members' dealings with us. We know that there are no members with small-time operations that are operating through the SFE's clearing house.*
>
> *Finally, I think that the level of supervision by the exchange itself slightly differs from that of the Sydney Futures Exchange, in that we have some mandatory requirements, such as capital base position limits, which are not available in Singapore. They are more discretionary. We believe some of our exchange procedures are different, if not more cautionary, because, frankly, we developed our*

most recent clearing system a little later than the Singapore Exchange did.[10]

2.3 Mr Hosking went on to explain that the level of exposure of Barings, which held up to half the positions in some contracts, would not go unnoticed on the Sydney Futures Exchange.

> *...I am aware of a general view amongst the Sydney Futures Exchange members that they do not feel comfortable with positions in excess of 15 to 20 per cent of the entire market, or trading activity at that level. It is not because they are self-regulators; it is because, once you build up a very large position or are one of the dominant players in a market, you set yourself up for the rest of the market to knock you down.*[11]

2.4 The SFE has an open outcry trading floor. This means that traders on the floor of the exchange can see what every other person is doing. Traders on the floor of the exchange will report unusually high volumes of trade to the SFE.

> *The reason people report that to us is that the clearing members of the Sydney Futures Exchange guarantee each other, so there is a compelling reason to actually make sure people are not overtrading. If there were a default, the other clearing members would have to pay the difference, so there is a self-regulation in the sense that their money is at risk.*[12]

2.5 Similarly the SFE accounting and margining procedures allow them to keep track of all activity on the exchange.

> *To protect ourselves against fraud and to ensure positions that are being traded and allocated to client accounts, we require mandatory client agreement forms. We have to validate those forms, to ensure that Mr Leeson is not trading a couple of thousand and hiding them somewhere within Barings. In fact, you cannot hide them from the exchange. All transactions on the exchange are recorded independently of the traders themselves. There is no trade*

10 Hosking, Committee Hansard, Sydney Futures Exchange, 6 March 1989, p. 5

11 Hosking, Committee Hansard, Sydney Futures Exchange, 6 March 1989, p. 10.

12 Hosking, Committee Hansard, Sydney Futures Exchange, 6 March 1989 p. 10.

that is actually executed that can be concealed from the exchange itself.

Members must, on a daily basis, report to us their customer accounts, when they exceed a certain level. That level is 100 contracts, which is a very low level. It is a very portable position that really just triggers awareness, so that, on average, we are aware of the owners of 90 per cent of the entire open position market. The other 10 per cent is in the hands of very small people. There is a difference in Singapore. It has only large reportable positions. It requires the positions to be reported at a much larger size than ours.

But once we go past reportable positions and our daily margining procedures, one of the most effective rules that we have is a capital based position limit, whereby on a mandatory basis we do not allow our members to build up positions which we believe would expose their entire net tangible assets. We measure the initial margins being paid to the exchange against their net tangible assets, which are reported to the exchange on a monthly basis, and we have limits as to how far those positions can be built up, vis-a-vis the net tangible assets.[13]

2.6 When the exposure by a particular firm gets over just a few per cent the SFE makes inquiries with the firms management to ensure that they are aware of the volume of trading and the risk to which their firm is exposed.

> *Since the New Zealand fraud back in 1987 we have been much more pro-active in our management of positions and making managers of the companies aware of what is happening. The New Zealand matter was where an individual purported that he was trading on behalf of a large fund in the United Kingdom and the fund in the United Kingdom knew nothing about that position. We discovered that there was insufficient contact by the exchange with the fund manager as to their awareness of it. A simple phone call would have brought this matter to a halt very early. As a matter of routine, we ring up senior managemen t- and we have done it with major banks and major institution - to bring to their attention the fact that they*

13 Hosking, Committee Hansard, Sydney Futures Exchange, 6 March 1995, p. 12.

have what we believe to be a significant position and question whether they are fully aware of the people that are controlling that position, the size of the margins and so on.

2.7 Mr Hosking also indicated that the SFE is vigorous in following up its inquiries with members who have unusually large positions. The exchange also has broad powers to take action against traders who have established such positions.

> *If we are not satisfied with the answers, we can impose what are called `super margins' on the member, and they have been done in the past. We are already getting initial margins which are an up-front payment of approximately one day's movement. If it cannot be satisfactorily demonstrated to us that management are fully on top of positions that they are accumulating, we simply ask for two or three times the initial margin levels, so there is more money with us. That has two effects: it starts to ensure that at least we can protect other members from this default that might be occurring; and it also has the effect of stopping them from trading, because they just cannot afford to any more.*
>
> *In some instances .... we have the power to stop members from actually trading any more positions, and perhaps even winding down positions, particularly if they exceed our capital-based position limits.*

2.8 The SFE indicated that its response to the development of large exposures had been effective in the past. The SFE has been prepared to make use of its powers when necessary.

> *Our capital base position limits have caused people to inject further capital because they have exceeded those limits. I think there have been one or two occasions when that has occurred in the last six months. It has been at least 12 months since we have placed additional margins on any single firm. It used to be a matter of regular activity in the 1980s when there were more volatile trading conditions and smaller sized members. In the last 10 years that I have been with the SFE I do not believe that we have caused a member to reduce a position under our instructions. We have certainly used moral suasion to ensure that they were fully aware of the position. We have alerted one or two of our members to*

positions that senior management were not aware of in the recent past.

2.9 The SFE also expressed confidence in the ability of the exchange to withstand major trauma in the markets.

> *I go back on the point that, notwithstanding what has happened to Barings in this incident, we came out of 1994 where there was more than a 2 per cent shift in interest rates and a massive reversal of the bond market, equivalent to the equities crash of 1987, with not one default and with not one blemish. We were nominated international derivatives exchange of the year last year as the premier exchange, not just because of our turnover but because of our regulatory structure.*[14]

2.10 When discussing the adequacy of the controls in place on the Singapore exchange at the time of the Barings collapse Mr Hosking said:

> *I think that the controls of the Singapore exchange were very good in a sense that they were asking questions, but perhaps not responding very well to the answers and not being as cautious as they ought to have been. But, overall, I think Baring Brothers London is the culprit in this collapse.*

2.11 It was put to Mr Hosking that the original notion of derivatives was that they were risk hedging. However, there now appeared to be a move to pure speculation. In response he said:

> *I think the move to speculation is overplayed, in the sense that Sydney Futures Exchange's percentage of speculation versus hedging is still 60 per cent true hedging versus 40 per cent speculation. There is an increase in participation in derivatives markets in general by what you would call the `heavy hitting' speculators, such as the commodity trading funds in the United States and the hedge funds, such as Sorres, out of the United States. There is a tendency for banks and institutions to trade principal, as opposed to doing customer business. I must emphasise that that seems to be what has happened with Barings.*

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14 Hosking, Committee Hansard, Sydney Futures Exchange, 6 March 1995, p. 38.

.....we will be concerned if there is an increase in outright speculation, particularly if it is done by major banks to try to increase their trading profits. But, we believe, as long as we are aware of it, are knowledgeable about it and can monitor it, it is not a risk.[15]

2.12 Mr Hosking was asked about the increased speculative trading in derivatives, especially over-the-counter derivatives, and whether more regulation was needed. In response he said

I do not believe that imposing regulation in the hope that it will stop collapses or defaults is appropriate. Certainly, in our opinion, the over-the-counter markets require greater disclosure of the risks being taken. That does not mean regulation; it just means that we all should be aware, either through self-regulatory bodies or through the regulators themselves, of the types of deals that are being struck and the size of the exposures being taken. It gets back to this point with regulations that there are plenty of examples where exchanges or marketplaces have had what is supposed to be the latest and best regulation and yet they have still failed because of mismanagement of that regulation.[16]

2.13 The Committee was interested in the ability of the present controls to detect large exposures being built up by a firm trading on several different futures exchanges. The Committee questioned the SFE about the extent to which it monitors the trading on other futures exchanges. In response the SFE indicated that it does not monitor, as an exchange clearing house, anything but the positions on the Sydney Futures Exchange. If Barings had had positions on Sydney Futures Exchange it would have known about those but it would not have known about the Singapore or Osaka positions.[17]

In the example, where Singapore and Osaka are dealing in the same contract, so that there is the ability for people to claim this arbitrage position, there should have been exchanges of information between the Singapore exchange and the Osaka exchange to

15 Hosking, Committee Hansard, Sydney Futures Exchange, 6 March 1995, p. 7.

16 Hosking, Committee Hansard, Sydney Futures Exchange, 6 March 1995, p. 10.

17 Hosking, Committee Hansard, Sydney Futures Exchange, 6 March 1995, p. 13.

crosscheck whether Mr Leeson was telling the truth about his equal and opposite position in Osaka.[18]

There appears to be a breakdown in communication there. I would expect that perhaps it is because of the intense rivalry between Osaka and Singapore to get the major share of business in the Nikkei 225 contract. We do not have any offsetting arrangements with any other exchange. We trade autonomous, indigenous Australian instruments that no other exchange trades.[19]

2.14 The SFE indicated to the Committee that this issue would be discussed at a meeting of the Futures Industry Association in Florida.[20]

2.15 The *Corporations Law* currently regulates derivatives under two separate chapters of the Law. Chapter 7 of the *Corporations Law* regulates trading in securities (defined in section 92) and the operation of securities exchanges. Chapter 8 sets out a different regime for trading in futures (defined in section 72) on a futures exchange. The distinction contained in the *Corporations Law* between securities and futures dates back to a period when derivatives markets were less well developed. The continuing growth in the range and nature of derivatives products has seen the creation of financial instruments which were not contemplated when the *Corporations Law* was initially framed and which do not fit clearly into either definition.

2.16 The result of this development has been a dispute between the ASX and the SFE over which definition new products fall under, which exchange is entitled to trade those products, and the relative levels of protection provided by Chapters 7 and 8 of the *Corporations Law*. The introduction by the ASX of Share Ratio Contracts was facilitated by amendments to the *Corporations Law* contained in the *Corporations Law (Securities and Futures) Amendment Act 1995*. That Act allowed the Government by regulation to define new hybrid products as either securities or futures.

2.17 During the Committee's hearings evidence was given on the merits, or otherwise of regulation under chapters 7 and 8. The SFE was critical of allowing derivatives contracts to be subject to Chapter 7 and traded on the ASX under its rules. It said that:

18 Hosking, Committee Hansard, Sydney Futures Exchange, 6 March 1995, p. 13.

19 Hosking, Committee Hansard, Sydney Futures Exchange, 6 March 1995, p. 13.

20 See paragraphs 3.7 - 3.9 and 3.11.

We are very strongly of the view that the chapter 8 Corporations Law provisions for the regulating of derivatives markets in Australia, in particular exchange trade of derivative markets, was designed to manage the risks that arise in these high risk instruments like futures. It was designed in the mid-1980s with a view to ensure that there was proper oversight to the volatile and high risk futures markets. There was a conscious decision by the draftsmen back in the mid-1980s not to use chapter 7 because it was inadequate for derivatives trading, for futures trading. It was a conscious decision.[21]

Our concern still is that they are basically voluntary rules. They are not embedded under chapter 8. Frankly, they are rules that are yet to be tested through the 1987 crash and the Bond market reversal. The history of the Sydney Futures Exchange's rules have been tested and their management has not been tested. The anomaly to us is that it seems to be a backward step in the prudent regulation of derivatives to water down chapter 8 now and to allow other people to trade.[22]

Australian Stock Exchange

2.18 The Committee conducted a public hearing with executives of the Australian Stock Exchange in Canberra on 27 March 1995.

2.19 The ASX also outlined its current derivatives trading safeguards:

We set strict capital adequacy requirements for brokers and monitor that compliance. We require every options transaction to be registered so that no trades can be concealed. We impose strict limits on the size of the options position any one client can have and on the total number of contracts that can be open over any one company's shares.[23]

We have a computer based margining system, which is also used by other major equities options markets around the world. Every trading day, this system calculates both risk margins based on the effects of a worst case overnight movement in the market, plus

21 Hosking, Committee Hansard, Sydney Futures Exchange, 6 March 1995, p. 28.

22 Hosking, Committee Hansard, Sydney Futures Exchange, 6 March 1995, p. 28.

23 Humphry, Committee Hansard, Australian Stock Exchange, 27 March 1995, p. 41.

margins to cover actual daily movements in the market, plus additional margins during the course of a trading day. If there is substantial market movement, these margins must be paid or we close out the contract. We do not just monitor the activities of brokers either. We also monitor every single one of their clients. We are one of the very few exchanges in the world to do so, to account down to the individual client level, and we are the only one in Australia.[24]

We have a separate computer based risk management system and if we find a broker has what we believe to be an unacceptable exposure, we ask the broker to close out the relevant contracts or inject further capital. In the event of default, we have the power to transfer positions or close out the broker's position. We have the same right to close out client positions.[25]

We also have one of the most sophisticated market surveillance operations in the world, ... It continuously monitors not only the equities market but also the options market for any sign of untoward activity. We swap that surveillance information with the Sydney Futures Exchange because they trade a futures contract over one of our share price indexes.[26]

Our systems require us to account to a client level rather than just to the broker level. We provide all the accounting processes for our member organisations so that they are able to have their position statements of each individual client. We are the only exchange in Australia and, as my inquiry shows so far, the only one in the world that accounts down to a client level. This enables us to make sure that the risks within the member organisation are not netted off against each other. We can see the gross risks at a client level rather than at the overall broker level. I receive a number of reports on my desk each day showing the largest positions of any of our member organisations, and if any situations look untoward then we will contact the member organisations and require them to either increase the amount of funding that they have into our clearing house, close out positions or move positions from their

24 Humphry, Committee Hansard, Australian Stock Exchange, 27 March 1995, p. 42.

25 Humphry, Committee Hansard, Australian Stock Exchange, 27 March 1995, p. 42.

26 Humphry, Committee Hansard, Australian Stock Exchange, 27 March 1995, p. 42.

organisations to a member organisation which may have better capital backing to support their client.[27]

We can tell at an instant, the level of risk of any particular client, we can tell clients across the different brokers so that if a client was to go to three different brokers, and if one broker did not realise that he was trading with another client, we would consolidate those positions. As a final test on a regular basis we look at what would happen if we had a major movement in the markets to see the impact on the clients themselves, the member organisations and on our clearing house, as to our funding position.[28]

One other lesson from its collapse is the importance of separating trading activities from the back office accounting function in order to provide independent checks. This is our clear policy. It is a fundamental tenet of any operation of checks and balances that there be a separation and we are impressing it on our stock broker members as part of our regular inspection program. We would not tolerate a merger of the two functions.[29]

Our present view is that the current audit checks and compliance program are sufficient assurance of separation, but we are considering whether a specific rule backed up by penalties would reinforce that policy. The final lesson from Barings is a more general management one, and I am perhaps more sensitive to it as a former auditor-general. It appears that the Barings collapse would not have happened if there had been appropriate disclosure or appropriate segregation of duties, appropriate responses to audit warnings and observance of basic prudential standards of financial management.[30]

2.20 In response to questions from the Committee about systemic risk, that is, the possibility that the collapse of one firm or market could cause a chain reaction in other firms or markets, the ASX advised it that it regularly tests the ability of the exchange to cope with major movements in the market.

27 White, Committee Hansard, Australian Stock Exchange, 27 March 1995, p. 59.

28 White, Committee Hansard, Australian Stock Exchange, 27 March 1995, p. 59.

29 Humphry, Committee Hansard, Australian Stock Exchange, 27 March 1995, p. 43.

30 Humphry, Committee Hansard, Australian Stock Exchange, 27 March 1995, p. 43.

We have nearly 20 years experience in derivatives trading, which includes the market break in 1987, a far more traumatic event, we suggest, than the Barings collapse and one that completely overwhelmed the Hong Kong Futures Exchange at the time. In all that time, no-one has lost money on our derivatives market through broker default. That is persuasive evidence that we operate a very well-regulated market.[31]

2.21 The Committee put the concerns of the SFE over the use of chapter 7 to regulate products, such as Share Ratio Contracts, which have some of the characteristics of futures. The ASX vigorously defended the regulatory arrangements which govern its trading in derivatives:

There have been some inaccurate comments made recently about ASX's derivative market being subject to only voluntary regulation. That is absolutely incorrect. There is nothing voluntary about it. The business rules under which all our markets operate are enforceable, not only as a contract between ASX and the stock broker members but specifically under section 777 and section 1114 of the Corporations Law. It is also important to recognise that our business rules themselves are subject to disallowance by the Attorney-General if he is not satisfied with them. Furthermore, our whole regulatory structure is reinforced by a series of memorandums of understanding with the Australian Securities Commission. We also meet regularly with the Sydney Futures Exchange in a number of forums to coordinate our activities in those areas of non-competitive subjects such as market security.[32]

There has also been a lot of talk about chapter 7 versus chapter 8 of the Corporations Law and the alleged gulf between them, but the fact is that the two chapters have many common features. In both cases, they do not stand alone but are supplemented by the various exchanges' business rules. To the extent that they do diverge, which is largely for historical reasons, there is no basis at all for claiming that one is superior to the other. They both provide a thorough and rigorous regulatory regime.[33]

31 Humphry, Committee Hansard, Australian Stock Exchange, 27 March 1995, p. 40.

32 Humphry, Committee Hansard, Australian Stock Exchange, 27 March 1995, p. 40.

33 Humphry, Committee Hansard, Australian Stock Exchange, 27 March 1995, p. 40.

2.22 However, while defending the level of regulation under the current arrangements the ASX commented that the structure of the *Corporations Law* in this area needs to be reviewed:

> *The real problem, I would suggest, is that we have a chapter 7 and a chapter 8 at all and the threat of a chapter 9, if someone dreams up a sufficiently different product from either options or futures. Perhaps we should be thinking along the lines of having a single generic chapter of the Corporations Law dealing with markets, with different products being dealt with by the much more flexible route of regulation - still, of course, subject to parliamentary scrutiny. There is no reason at all why that approach should lead to less well-regulated markets, but it would make innovation a lot easier and product innovation is one of the keys to the Australian markets competing successfully with the rest of the world, which is another concern of this committee.*[34]

2.23 The Committee also raised its concerns about the possibility that an investor may operate on more than one exchange and build up a series of positions which are individually unremarkable, but when taken in combination are a matter of concern for market operators and regulators. While the controls on any single exchange, such as the ASX, may be adequate, it may also be necessary to ensure that there is an adequate exchange of information between exchanges. This exchange of information is occurring between the SFE and the ASX:

> *The issue in relation to Barings was that there was a common contract traded between Osaka and Simex, and there it would seem that there was not the close discussion between the two markets as to the growing positions on either of the markets. There is a requirement for us here in Australia where we have a memorandum of understanding between ourselves and the Sydney Futures Exchange, where there is a linked product or process. For example, they trade a share price index contract and we trade individual shares or the option contracts over those shares. We share information.*[35]

34 Humphry, Committee Hansard, Australian Stock Exchange, 27 March 1995, p. 41.

35 Humphry, Committee Hansard, Australian Stock Exchange, 27 March 1995, p. 61.

2.24 The Committee was concerned not only with trading on exchanges within Australia but also with the possible consequences of trading on international exchanges. The Committee asked the ASX about this issue.

> *There is going to be a major difficulty ahead in maintaining appropriate contact on cross border flows. I do not think anybody in the world would have a solution to that at the moment. How one would go about corralling all of the exchanges - and there are literally hundreds of them - I think would be a daunting task. But what would be required before information flow would be some form of standardisation of disclosure across different countries. That is something which I would hope that the Australian Securities Commission would be raising through IOSCO, which is the body for international securities regulation.*
>
> *At an international level, if we wanted to list our Australian products on an American exchange, before we could do that we would have to enter into an agreement with the International Surveillance Group, which is set up between regulators, to make sure that there is a sharing of information. I do not believe that such an arrangement was between Osaka and Simex on their particular contract. Certainly we would not enter into a product on another market where we did not have the proper surveillance arrangements in place through a memorandum of understanding with the linked exchange.*
>
> *I do think that in the future there are going to be more products that are traded on a 24 hour style basis around the world, and it will be necessary for there to be arrangements in place, memorandums of understanding, between the exchanges where those products are traded.*[36]

Australian Securities Commission

2.25 The Committee conducted a public hearing with the Chairman and senior staff of the Australian Securities Commission in Canberra on 29 March 1995.

36 Humphry, Committee Hansard, Australian Stock Exchange, 27 March 1995, p. 61.

2.26 In commenting on the Barings collapse Mr Cameron, the ASC Chairman, said that:

> *The collapse of Barings is, of course, the latest in a line of large disasters reported by derivatives market participants. Among them are the German industrial conglomerate, Metallgesellschaft; US corporates such as Procter and Gamble, and Gibson Greeting; and, to the extent that it involved derivatives, Orange County, in California.*[37]
>
> *Until Barings, recent regulatory and media attention has focused mostly on the potential risk of over-the-counter derivatives. Two issues have been at the centre of much discussion. Firstly, the risks that are involved in OTC derivatives trading, the complexity of many of the transactions, and consequent doubts as to whether participants - especially corporate users - fully understand and, therefore, adequately manage the risks that they assume in derivatives markets. Secondly, because a comparatively small number of firms dominate market making in these over-the-counter derivatives, the risk that the failure of a significant intermediary, perhaps caused by the default of a major customer, may lead to severe disruption in derivatives markets, or in financial markets generally. This, of course, is known as systemic or interconnection risk.*[38]
>
> *When we look at what has happened in the Barings collapse, some features of the trading and regulatory environment seem to have performed well. In particular, firstly, the clearing system associated with the Simex exchange in Singapore appears to have functioned well. The clearing house was kept in funds. Barings did not in fact default on its margin obligations until the day it collapsed. The ASC understands that the clearing house has now returned money to the Barings administrators. It also seems that the clearing house queried Barings, including its London management, on a number of occasions from January on, about the size of its positions and its exposure.*

37 Cameron, Committee Hansard, Australian Securities Commission, 29 March 1995, page 145-6.

38 Cameron, Committee Hansard, Australian Securities Commission, 29 March 1995, p. 146.

> *Secondly, no client of Barings lost funds deposited with Barings for futures trading purposes. Thirdly, after the failure, there seems to have been effective cooperation between exchanges and regulators in Singapore, Japan, the United Kingdom and the United States. This cooperation concerned identifying, transferring and winding down the positions held by Barings and its clients. Finally, at this stage, there are few signs of significant flow-on or systemic problems caused by the Barings collapse. The speed with which the sale of Barings to ING was effected is likely to have been an important factor in averting the threat of a more general liquidity crisis.*
>
> *On the other hand, a number of possible problems in the system may be identified in a preliminary way. Firstly, it seems that UK clients of Barings dealt on Simex through an omnibus client account, and were treated as a single client by Barings Singapore. Ultimate client identities were not easily ascertainable. This probably contributed to delay in the transfer of positions to other Simex clearing members, and potentially left clients exposed to continuing deterioration of their positions.*
>
> *Secondly, prior to the collapse, there seems to have been a lack of transfer of information between exchanges and regulatory authorities in Singapore and Japan. This is likely to have been exacerbated by the fierce commercial competition between Simex in Singapore - which is, after all, a futures exchange - and the Osaka exchange, which is a stock exchange in Japan, for business on the Nikkei 225 index contract, which is listed on both exchanges.*
>
> *Thirdly, Japanese exchange rules permit house and customer funds to be lumped together for the purpose of calculating margin obligations. That is, the margins that have to be paid relate only to the overall net position of the broker, without regard to the position of the individual clients or the house. This may have complicated or delayed returns to Barings clients in relation to trading in Japan.*
>
> *Finally, complications with insolvency law across national boundaries seem to have caused delays in the orderly winding down of positions, including client positions. While all these problems are a source of some concern, it seems that above all it was internal arrangements at Barings that led to its failure. In particular, the*

following features of internal controls-or lack of them-appear to have been precipitated the collapse.

Firstly, there was the structure of the Singapore branch office, with-it appears-Singapore management having little direct authority over the trading activities of Mr Leeson. Secondly, there was Barings' apparent lack of an effective risk management system, including limits on trading authority and methods of monitoring group exposures on a real time or daily basis. Thirdly, there was the failure by Barings London to verify the accuracy of information supplied by its Singapore office or by individuals within it. Finally, the front office and back office functions in Singapore were not being effectively segregated, so that the person responsible for trading was also authorising trading related payments.[39]

2.27 Mr Cameron went on to discuss how the lessons from the Baring's crash could be applied in Australia.

How do we apply those lessons, at this stage - to the extent that you can apply them at all, in Australia? If Barings is seen as an example of the failure of a derivatives market participant because of wrong trading decisions, it is impossible and undesirable to guarantee that it could not happen in Australia or, indeed, in any other jurisdiction. If you view Barings as an instance of how poor management controls can lead to a fatal level of exposure on the wrong side of the market, it is again hard to say that it could not happen here - especially since it already has, some years ago, in the case of AWA.

Despite that, the ASC is reasonably confident that the chances of trading on Australian markets resulting in something on the same scale as the Barings collapse are remote. The way in which the SFE supervises its markets means that a rapid build-up of positions would be likely to be detected and dealt with at an earlier stage than the Barings positions seem to have been, and that the ASC, as regulator, would be involved at an early stage.

But it is not hard to envisage situations which may make the risks larger and the tasks of identifying problems at an early stage more difficult. For example, positions may be held on a number of

39 Cameron, Committee Hansard, Australian Securities Commission, 29 March 1995, page 146-148.

exchanges in a number of jurisdictions, as they were in the Barings case, or derivatives market dealings by a large conglomerate may be undertaken through a number of separately incorporated vehicles. It would, therefore, be a mistake to be entirely sanguine about the possibility of a Barings happening in Australia. Equally, the ASC believes that the regulatory regime should not be seen as a panacea. Barings should not result in a `there ought to be a law against it' response. As a community, we need to understand clearly what we expect from the regulation of derivatives markets, especially OTC markets. In the ASC's view, what the community looks for primarily ought to be the protection of inexperienced investors, contributions to the stability of markets, and a reasonable assurance that brokers and other market intermediaries have adequate financial resources to honour their obligations to clients and to other market participants. We should not expect regulation to guarantee that no-one fails. Rather, what we should aim for is a system that allows for failure but minimises the damage of fallout in that event.

There have been few instances of the failure of derivatives market intermediaries in Australia since the introduction of the Futures Industry Code in 1986. All date back to the 1980s. Based on experience with these instances, if a failure like Barings did occur in Australia, first, the transfer of client positions to well capitalised members of the SFE would be achieved within 24 hours, and would not stretch out over several weeks, as it appears to have done in Singapore. Second, the segregation of client funds, both at broker and clearing house level, should simplify the identification of all ultimate holders of positions and return of funds to those clients.

As for the segregation of back office and trading functions, that is in fact universal among SFE members, but it is not expressly required by SFE rules or by the Corporations Law. Rather, the futures exchange has a policy of requiring it and would invoke general provisions of its rules against a member if non-segregation was detected. Since the Barings collapse, regulators and industry participants alike have focused on the need for derivatives market participants to adopt best practice risk management practices, including structures. The extent to which the regulatory regime should mandate management practices and structures, which of necessity must be appropriate to the circumstances of each firm and capable of rapid change, is questionable. It is doubtful, indeed,

whether the ASC presently has power under the licensing provisions to require the separation of front office and back office functions. Moreover, it is not clear that the regulatory regime should mandate any specific internal management arrangements. To do so may mean that matters which the law currently deals with under the general heading of directors' obligations become the subject of narrow and inflexible rules, and they may provide a false sense of security.[40]

2.28 Mr Cameron also outlined for the Committee the principle steps that the ASC has undertaken in response to the Baring's collapse.

The final thing I would say is this: I am very concerned not to leave the impression that the commission is complacent about Barings or its implications. We certainly did not react complacently. On the day that the announcement was made I spoke to the head of the futures exchange myself on two occasions, and later in the same week. Since 27 February I have discussed the Barings issue at meetings in Kuala Lumpur and Bangkok. At Bangkok there were representatives at the Japanese and Singapore regulators. I spoke in Bangkok also with the Chairman of the UK Securities and Investment Board, and when he came to Sydney the following week, the Council of Financial Supervisors had lunch with him and discussed little else.

There was then a meeting of the international organisation's technical committee in Sydney on 15 March and on that occasion again we had present the Chairman of the Securities and Investment Board, senior members of the Commodity Futures Trading Commission, the Securities and Exchange Commission, the Securities Board from Japan and a representative of the UK treasury. And we have therefore given the matter considerable attention.

A representative for the ASC attended the meeting in Boca Raton, which Mr Hosking spoke to you about when he was giving evidence, and I have therefore a preliminary report from that meeting as well. And it is also true that the Commodity Futures Trading Commissioner and the Securities and Investment Board are proposing a special working group of leading world regulators to review the full implications of the Barings collapse when they emerge. I expect a formal invitation to me to attend that meeting to arrive in the next few days.

So the ASC is not sanguine or complacent about Barings but on the other hand I think we have an equal responsibility to ensure that there is not an over reaction to it or any lack of confidence in what we still believe is one of the better regulated exchanges in the world.[41]

2.29 Mr Cameron informed the Committee that the ASC has memorandums of understanding with both the Sydney Futures Exchange and the Australian Stock Exchange which provide for the immediate referral to the ASC of matters which may involve serious breaches of the exchanges business rules or the *Corporations Law*. The ASC has established a specialist futures industry team and in 1994 arranged for the secondment of an senior officer from the United States Commodity Futures Trading Commission to review the effectiveness of the SFE's supervision of its trading. In his opening statement to the Committee Mr Cameron said:

The ASC is currently building on these arrangements to ensure that the future supervision of the SFE markets is based on a sensible use of resources and on clearly delineated roles for the exchange and the Commission. For example, it is our view that we will contribute most effectively not by having a system of parallel supervision of the market and the members but by conducting periodic intensive audits of the effectiveness of the Futures Exchange's supervision in these areas.[42]

2.30 The Committee raised the issue of the dispute between the ASX and the SFE over the level of regulation of the stock exchange's derivatives markets. In his evidence before the committee Mr Cameron indicated that he was satisfied that the Share Ratio contracts would be subject to an appropriate regulatory regime which would ensure that the appropriate level of investor protection is available for these products.[43]

40 Cameron, Committee Hansard, Australian Securities Commission, 29 March 1995, page 148-150.

41 Cameron, Committee Hansard, Australian Securities Commission, 29 March 1995, page 150-151.

42 Cameron, Committee Hansard, Australian Securities Commission, 29 March 1995, p. 143.

43 Cameron, Committee Hansard, Australian Securities Commission, 29 March 1995, p.162.

2.31 The Committee asked the ASC about the possibility of reforming the law to incorporate the regulation of all derivatives markets under a single regime. In response the ASC said:

> *The other thing to add to that is that the ASC's report, which was really one of the things that stimulated and has focused the CASAC review, has made suggestions about what a regime might look like in the future and it does suggest that there are substantial opportunities for simplifying the legislation and making it both more rational and more even handed in the way that it applies. Part of that does apply to doing away with distinctions that are currently maintained in chapter 7 and chapter 8 and saying that there is no need for regimes which are substantially the same to be set out in different chapters. The suggestion you make is one that generally the commission has suggested should be thoroughly explored in the law reform review process.*[44]

2.32 The ASC has been reviewing the law regarding derivatives. In May 1994 it published its *Report on Over-the-Counter Derivatives Markets*[45]. That Report examines the nature, size, participants and risks involved in derivatives markets and proposes changes to the regulatory framework for derivatives markets. The Report recommended that there should be a review of the complex regulatory and law reform issues arising from increased activity in OTC derivatives transactions. It set out the following main objectives for such a review:

> *The law reform review should have the following main objectives:*
> - *to ensure similar regulatory treatment of products with similar functional characteristics;*
> - *to ensure that the scope and content of the legislation properly reflect changed market circumstances, and are sufficiently flexible to allow continuing development of new products and market techniques;*
> - *to remove existing anomalies and uncertainties in the regulation of products with substantially similar functional characteristics; and*
> - *to identify opportunities for simplification of the regulatory regime.*[46]

2.33 The Report's recommendations suggest that the review deal with a number of specific of issues including:
- eliminating unnecessary distinctions between securities and derivatives markets;
- adopting the concept of "regulated derivatives transaction" covering derivatives which are currently classified as futures or securities or are unregulated;
- the use of risk disclosure statements, the desirability of limiting advertising of derivatives, possible limitations on retail dealings in OTC markets and the introduction of a general prohibition on misleading and deceptive conduct in relation to derivatives transactions;
- licensing of derivatives markets intermediaries.[47]

Corporations and Securities Advisory Committee

2.34 The Committee conducted a public hearing with the Executive Director and Members of the Companies and Securities Advisory Committee in Canberra on 30 March 1995. The Advisory Committee is currently engaged in a review of derivatives regulation. It commenced its review in mid-1994 following the release of the ASC *Report on Over-the-Counter Derivatives Markets*. The review was prompted by the rapid growth in volume, diversity and complexity of the Australian and overseas derivatives markets. To assist its review, the Advisory Committee established an expert advisory panel drawn from the SFE, the ASX, the ASC the Reserve Bank, industry, the legal and accounting professions, and academics. A list of the members of the Panel appears at Appendix A.

2.35 The Corporations and Securities Advisory Committee has already published an international comparison of derivatives regulation[48] and recently a discussion paper entitled Regulation of the OTC Derivatives

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44 Mr Malcolm Rodgers, Committee Hansard, Australian Securities Commission, 29 March 1995, p.163-4.

45 Australian Securities Commission, *Report on Over-the-Counter Derivatives Markets*, May 1994.

46 Australian Securities Commission, *Report on Over-the-Counter Derivatives Markets*, May 1994, p. 50.

47 Australian Securities Commission, *Report on Over-the-Counter Derivatives Markets*, May 1994, page 3-8.

48 Companies and Securities Advisory Committee, *Law of Derivatives: An International Comparison*, January 1995.

Market[49]. The discussion paper proposes a range of regulatory initiatives designed to enhance existing controls over the Australian OTC market. The proposals are intended to:

- clarify the scope of OTC derivatives regulation and the rights of participation by retail end-users;
- impose conduct, risk management and prudential obligations on intermediaries through a licensing regime;
- protect the OTC market against improper practices; and
- increase legal certainty for OTC participants.[50]

2.36 The Advisory Committee is currently seeking submissions on its proposals and the issues raised in the discussion paper. The Advisory Committee intends to publish a further discussion paper on the regulation of exchange traded derivatives and the regulation of a possible secondary or tradeable OTC market.

2.37 The Committee asked witnesses about the appropriateness of the CASAC review in light of the concerns raised by the Barings crash. In response to a question from the Committee about whether the CASAC timetable was appropriate Mr Cameron said:

> *Yes. I do not think that Barings gives me any reason to think that we are in a state of crisis. Apart from anything else, the chief focus of the CASAC report is OTC markets, and the whole Barings episode is, of course, exchange traded - and not exactly complex instruments - they are instruments even I can understand.*[51]

2.38 The Committee also asked the SFE is they were satisfied with the process and the progress that is being made.

> *Yes. One can always hope that these things can be resolved more quickly, but I think the important thing is that every interested party has an opportunity to present their views and that we produce a result which is accepted as workable and effective. That is the key thing, rather than to rush something through. There has been a very wide consultative process, and there is a reasonably strict timetable which will lead to a result and, certainly, a report this year.*[52]

49 Companies and Securities Advisory Committee, *Regulation of the OTC Derivatives Market*, August 1995.

50 Companies and Securities Advisory Committee, *Regulation of the OTC Derivatives Market*, August 1995, p 2.

51 Cameron, Committee Hansard, Australian Securities Commission, 29 March 1995, p.155-156.

Could a Major Derivatives Collapse Occur in Australia

2.39 The Committee was concerned that a collapse could occur in Australia in a similar manner to Barings.

2.40 The Committee asked witnesses whether they could guarantee that a Barings type collapse could not happen here. No witness gave such a guarantee.

Sydney Futures Exchange

> *A guarantee is probably too high a commitment from me. Certainly, I am confident that what has happened in Singapore, from what we know of it at this stage, would be highly unlikely to occur in Australia. We believe that we have management control systems, both at the exchange and amongst our members, which would have prevented or at least detected two or three of the fundamental breakdowns that have occurred in Singapore.*[53]

Australian Stock Exchange

> *I can provide an assurance to the Committee that, so far as systemic risk is concerned, we believe that we have more than adequate procedures in place to give comfort on that score. I do not believe that any system - regulatory or business rules - can ever legislate against fraud or non-compliance with rules. .... I think it is important to keep in perspective that you can legislate for good systems, but you cannot guarantee - and therefore I cannot guarantee to you - that fraud could not happen. But it would require a breakdown of systems for that to occur.*[54]

Australian Securities Commission

> *If Barings is seen as an example of the failure of a derivatives market participant because of wrong trading decisions, it is impossible and undesirable to guarantee that it could not happen in*

52 Dreise, Committee Hansard, Sydney Futures Exchange, 6 March 1995, p. 33.

53 Hosking, Committee Hansard, Sydney Futures Exchange, 6 March 1995, p. 5.

54 Humphry, Committee Hansard, Australian Stock Exchange, 27 March 1995, p. 58.

Australia or, indeed, in any other jurisdiction. If you view Barings as an instance of how poor management controls can lead to a fatal level of exposure on the wrong side of the market, it is again hard to say that it could not happen here - especially since it already has, some years ago, in the case of AWA.[55]

Despite that, the ASC is reasonably confident that the chances of trading on Australian markets resulting in something on the same scale as the Barings collapse are remote. The way in which the SFE supervises its markets means that a rapid build-up of positions would be likely to be detected and dealt with at an earlier stage than the Barings positions seem to have been, and that the ASC, as regulator, would be involved at an early stage.[56]

Corporations and Securities Advisory Committee

We do not see it as the task of the advisory committee to attempt to eliminate the risks inherent in derivatives or to counter the consequences of poor investment strategies. Indeed, we would be concerned that any industry based initiatives or regulatory response in Australia should not intentionally or inadvertently encourage the view that the real financial risks associated with derivatives have somehow disappeared or been minimised. The advisory committee notes and endorses the comment of the ASC chairman Alan Cameron that it is impossible and undesirable to guarantee that a Barings type disaster could not happen in Australia. Rather, the advisory committee plans to recommend a means of better conducting both the exchange traded and over-the-counter derivatives markets.[57]

55 Cameron, Committee Hansard, Australian Securities Commission, 29 March 1995, p. 148.

56 Cameron, Committee Hansard, Australian Securities Commission, 29 March 1995, p. 148.

57 Mr Leigh Hall, Committee Hansard, Corporations and Securities Advisory Committee, 30 March 1995, p. 19.

3. Recent Developments

Reports on Barings

3.1 Recently two reports have been issued following investigations into the Barings crash. In July 1995 the Board of Banking Supervision of the Bank of England reported on its investigation into the events leading to the collapse of Barings. The report placed the responsibility for the crash on Mr Leeson and on the management of Barings. In examining the lessons arising from the collapse of Barings the report said:

> *Barings' collapse was due to the unauthorised and ultimately catastrophic activities of, it appears, one individual (Leeson) that went undetected as a consequence of a failure of management and other internal controls of the most basic kind. Management failed at various levels and in a variety of ways, described in the earlier sections of this report, to institute a proper system of internal controls, to enforce accountability for all profits, risks and operations, and adequately to follow up on a number of warning signals over a prolonged period. Neither the external auditors nor the regulators discovered Leeson's unauthorised activities.*[58]
>
> *... we would emphasise the following five significant lessons of the Barings case, which we discuss later in this section, to which particular attention needs to be paid:*
>
> *(a) Management teams have a duty to understand fully the businesses they manage;*
>
> *(b) Responsibility for each business activity has to be clearly established and communicated;*
>
> *(c) Clear segregation of duties is fundamental to any effective control system;*
>
> *(d) Relevant internal controls, including independent risk management, have to be established for all business activities;*

58 Board of Banking Supervision of the Bank of England, *Report of the Board of Banking Supervision Inquiry into the Circumstances of the Collapse of Barings, 18 July 1995, p. 250.*

(e) Top management and the Audit Committee have to ensure that significant weaknesses, identified to them by internal audit or otherwise, are resolved quickly;[59]

3.2 In October the Singapore Ministry of Finance released a report it commissioned from Price Waterhouse into the Baring collapse. Media reports indicate that the Price Waterhouse report was highly critical of the management of Barings. It not only criticised the internal controls of the bank but also suggested that senior executives of Barings may have covered up Mr Leeson's losses.

3.3 The Committee has not yet had the opportunity to examine these reports in detail but it will follow these matters up during future hearings with the ASX, SFE and ASC.

International Developments

Windsor Declaration

3.4 In May 1995 representatives of regulatory bodies from 16 countries, including the ASC, met at Windsor in the United Kingdom. The result was the Windsor Declaration which outlines measures aimed at strengthening the supervision of international futures markets.

3.5 In the Declaration the regulatory authorities agreed to promote:

- Active surveillance within each jurisdiction of large exposures by market authorities and/or regulators;
- Development of mechanisms to separately identify and hold safe customer positions, funds and assets as far as possible;
- Enhanced disclosure by the markets of the different types and levels of protection of customer funds and assets;
- Record-keeping systems at exchanges which ensure that positions, funds and assets belonging to customers can be distinguished from others;
- Enhanced disclosure by markets to participants of the rules and procedures governing defaults;
- The immediate designation by each regulator of a 24 hour contact point for receiving information or providing other assistance to other regulators and/or market authorities;

59 Board of Banking Supervision of the Bank of England, *Report of the Board of Banking Supervision Inquiry into the Circumstances of the Collapse of Barings, 18 July 1995, p. 250.*

- Review of existing lists and assuring maintenance by IOSCO of an international regulatory contacts list;
- The development or review by financial intermediaries, market members or markets and regulatory authorities of contingency arrangements.

3.6 The supervising authorities also recommended that further work should be undertaken with respect to:

- co-operation between market authorities;
- protection of customer positions, funds and assets;
- default procedures; and
- regulatory co-operation in emergencies.

Futures Industry Association

3.7 In March 1995 the Futures Industry Association held its annual international futures industry conference in Boca Raton, Florida. During that meeting the FIA formed an international task force to examine the safeguards and control mechanisms that exist in the industry. In June 1995 the Futures Industry Association Global Task Force on Financial Integrity published its recommendations on derivates exchanges, brokers and customers[60]. The introduction to its report states that:

> *... events surrounding the Barings failure prompted market participants to consider certain national and cross-border issues related to the structure and operation of the international markets for exchange-traded and/or cleared futures and options. The most significant of these issues included the mechanisms that exist for the protection of participants' assets, the internal controls and risk management procedures employed by exchanges/clearinghouses, broker/intermediaries and customers, and the communication of information regarding the activities of market participants by exchanges/clearinghouses and regulatory authorities.*
>
> *The Future industry Associations Global Task Force on Financial Ingrate was organised in March 1995 to address these issues. The Task Force includes representatives of major international exchanges/clearinghouses, brokers/intermediaries (including*

60 Futures Industry Association Global Task Force on Financial Integrity, *Financial Integrity Recommendations For Futures and Options Markets and Market Participants,* June 1995.

futures commission merchants and other brokers) and customers from 17 jurisdictions.[61]

3.8 The Task force made a total of 60 recommendations directed at regulators, exchanges, brokers and customers. The recommendations deal with a wide range of issues including protection of exchange members, margin requirements, dissemination of information, transfer of the positions of customers in difficulty, information sharing, audits, risk assessment and management ,bankruptcy, coordination and oversight by regulatory authorities, legal relationships, and internal controls.

3.9 Some of the recommendations address specific issues arising out of the Barings crash such as the separation of back office personnel from traders (recommendations 46 and 58), the exchange of information between futures exchanges when brokers are arbitraging (recommendation 13), and trading by omnibus accounts (recommendation 36).

Review of SFE Procedures

3.10 The Sydney Futures Exchange has reviewed its procedures in light of the Barings collapse. It has advised the Committee that:

- the SFE has decided to require members of the exchange to report the details of the holders of every open position daily.
- The SFE clearing house has decided to increase the minimum net tangible asset requirement for members from $2 million to $5 million.
- The SFE will shortly be making a submission to the Companies and Securities Advisory Committee concerning changes which the exchange believes should be made to the *Corporations Law* in order to bring it into line with best international practice.

3.11 The SFE was involved in the Florida meeting of the Futures Industry Association in March 1995 which discussed issues arising out of the Barings crash. The SFE was also involved in the development of recommendations by the Futures Industry Association's Global Task Force on Financial Integrity. The SFE has advised that Committee that the SFE and the Sydney Futures Clearing House satisfy every one of the recommendations relating to exchanges and clearing houses.

61 Futures Industry Association Global Task Force on Financial Integrity, *Financial Integrity Recommendations For Futures and Options Markets and Market Participants,* June 1995, p. 6.

Accounting Standards

3.12 The Australian Accounting Standards Board and the Public Sector Accounting Standards Board have released exposure draft ED 65 on financial instruments (including derivatives). The proposed standard would require disclosure of the nature, terms and conditions of financial instruments, the objectives for holding or issuing derivatives, exposure to interest rate and credit risk and the net market values of classes of financial assets and liabilities. The exposure draft is based on International Accounting Standard IAS 32 "Financial Instruments - Disclosure and Presentation"

House of Representatives Banking, Finance and Public Administration Committee

3.13 As a result of concerns arising from the Barings crash, the House of Representatives Standing Committee on Banking, Finance and Public Administration decided to examine the role of the Reserve Bank of Australia in the supervision of derivatives trading in the banking system. The Committee also conducted a public hearing with the Insurance and Superannuation Commission. On 25 September 1995 it tabled its report *Review of the Reserve Bank of Australia's 1993-94 Annual Report and The Insurance and Superannuation commission's 1993-94 Annual Report.*

3.14 During its hearings the Banking Committee examined the size and regulation of Australia's derivatives markets, the guidelines produced by the Basle Committee on Banking Supervision on the oversight of risk management practices, the controls that Australian banks had in place to manage derivatives activities, systemic risk and netting.

3.15 The Banking Committee expressed general satisfaction that the Reserve Bank has adopted a responsible and thorough approach in dealing with the potential risk that derivatives could pose to the stability of the financial system.[62]

3.16 The Banking Committee questioned the Insurance and Superannuation Commission on the use of derivatives products in the insurance and

62 House of Representatives Standing Committee on Banking, Finance and Public Administration, *Review of the Reserve Bank of Australia's 1993-94 Annual Report and The Insurance and Superannuation commission's 1993-94 Annual Report,* p.17.

superannuation industry. The ISC said that quarterly returns from insurance companies indicated that the life companies use derivatives minimally and mainly for hedging purposes. The ISC has issued discussion papers which concentrate on risk managements procedures for insurance and superannuation.

3.17 However, the ISC told the Banking Committee that superannuation funds have not been required to report on the use of derivatives in the past and the ISC is unable to quantify the use of derivatives in the superannuation industry.

3.18 The Banking Committee expressed concern about this situation;

> *The Committee is concerned at the lack of knowledge about the use of derivatives in the superannuation industry in particular. The ISC advised that 'the use of derivatives by life insurance companies, superannuation funds and general insurance companies in an overall context is relatively small. Apart from a general feeling, I cannot give you any further guidance.*[63]
>
> *While the Committee endorses the approach of the ISC, the regulatory regime with regard to superannuation and insurance is still being formulated The growing importance of superannuation requires that the ISC ensure that the process initiated with the release of the discussion papers be advanced as a matter of priority. The Committee was particularly concerned at the lack of data available on the use of derivatives by superannuation funds and will consider further examining the ISC's progress in this matter when it receives the ISC's 1994-95 annual report.*[64]

3.19 The Banking Committee ended its comments on its hearing with the ISC by emphasising the importance it attaches to superannuation and recommending that the Treasurer monitor developments.

> *The Committee considers that the ISC should place a high priority on finalising the new regulatory approach for the use of derivatives by superannuation funds. The emphasis now placed on superannuation means that it may represent the life savings of many Australians and those savings need to be afforded the maximum possible protection. The ISC does not guarantee the funds of members, although the Treasurer does have the power under the SIS legislation to require a levy from other superannuation funds if a particular fund gets into difficulties. The ultimate responsibility lies with trustees and it is important that the ISC be satisfied that trustees are aware of their responsibility to ensure that sensible investment strategies are being followed and that appropriate risk management strategies are in place.*
>
> *The present lack of information regarding the investment activities of superannuation funds is cause for concern and it needs to be addressed as soon as possible.*
>
> ***The Committee recommends that:***
>
> > ***the Treasurer monitor the implementation of the Insurance and Superannuation Commission's proposals for the use of derivatives by superannuation funds and report to Parliament on progress at the first opportunity in 1996.***[65]

3.20 On 19 October 1995 the Banking Committee again questioned the Reserve Bank about derivatives and the role of the ISC. In commenting on the Bank of England report Mr Fraser said:

> *... I think the findings that have been released in the Bank of England report .... have highlighted the things that we are on the track of in any case, and have caused us and the banks themselves to give appropriate attention to all these things. But I think it is fair to say that, in summary, everything is proceeding pretty much on track in that area.*[66]

63 House of Representatives Standing Committee on Banking, Finance and Public Administration, *Review of the Reserve Bank of Australia's 1993-94 Annual Report and The Insurance and Superannuation commission's 1993-94 Annual Report*, p.17

64 House of Representatives Standing Committee on Banking, Finance and Public Administration, *Review of the Reserve Bank of Australia's 1993-94 Annual Report and The Insurance and Superannuation commission's 1993-94 Annual Report*, p.17.

65 House of Representatives Standing Committee on Banking, Finance and Public Administration, *Review of the Reserve Bank of Australia's 1993-94 Annual Report and The Insurance and Superannuation commission's 1993-94 Annual Report*, p.16.

66 Fraser, Hansard, House of Representatives Standing Committee on Banking, Finance and Public Administration, 19 October 1995, p. 28-29.

4. CONCLUSION

4.1 Derivatives trading is a growing area of financial activity. It provides market participants with the ability to benefit from the careful management of existing risk. It also allows them to undertake new risks and make speculative profits and losses.

4.2 The Committee's hearings were stimulated by four main areas of concern. First to ensure that the *Corporations Law* has kept up with developments and provides a suitable regulatory environment for derivatives trading. Second, that regulators and market operators are aware of the full range of hazards involved in derivatives trading and are able to ensure, as far as possible, the overall integrity of the markets. Third, that market participants are aware of the hazards involved in trading these products, and, finally, that the superannuation savings of Australians are not placed at risk by derivatives trading.

4.3 Based on the evidence given during its hearings the Committee can see no reason for new legislative restraints on the use of derivatives at this stage, but it will continue to monitor developments. Similarly the Committee saw no reason for restricting the development of new products provided that:

- an appropriate regulatory regime is in place;
- active consideration is given to the need for suitable limitations on the level of exposure of individual users; and
- the nature of the product and the potential risks involved are adequately publicised.

4.4 However, the evidence before the Committee suggests that the present regulatory arrangements under the *Corporations Law* should be reviewed. In particular the division of the regulation of markets into two separate chapters of the *Corporations Law* appears to be inappropriate and argument about the relative merits of the two regimes may distract attention from the real issues. The regulatory regime should provide a sound market structure which provides appropriate protection for investors. The Committee believes, and it appears to reflect the current thinking in the industry, that Chapters 7 and 8 should be reviewed and replaced with a more appropriate single regulatory structure.

4.5 The process of reviewing the *Corporations Law* is already underway. The report by Australian Securities Commission on Over-the-Counter

Derivatives Markets[67], the International Comparison published by the Companies and Securities Advisory Commission[68] and its discussion paper on *Regulation of the OTC Derivatives Market* [69] have already laid down some of the groundwork for such a review. The Committee, however, wishes to remain satisfied with the pace and direction of the review and will continue to monitor its progress.

4.6 The Committee's second concern is that regulators and market operators are aware of the full range of hazards involved in derivatives trading and in operating a derivatives market are able to ensure, as far as possible, the overall integrity of the markets. The hearings which the Committee has conducted have not fully examined every aspect of derivatives trading and the operations of the exchanges. However, it appears to the Committee that all three bodies are actively reviewing the way in which the markets operate in Australia in the light of overseas experience and are seeking to effect best practice.

4.7 The Committee recommends that the ASC include in its Annual Reports a synopsis of the types and volumes of derivatives being traded in Australia and recent regulatory developments.

4.8 The Committee's third area of concern is that inexperienced market participants may suffer serious losses as a result of their involvement in derivatives markets. The level of protection for inexperienced users of these products was considered in the ASC report on Over-the-Counter derivatives and will be considered by the Corporations and Securities Commission Advisory Committee.

4.9 The Committee is of the view that the primary responsibility for ensuring that individual businesses do not fail as a result of losses on the derivatives markets rests with the management, directors and shareholders of those firms. The losses sustained by both Australian and overseas businesses should serve as a salutary warning for Australian businesses of the consequences of becoming involved in derivatives trading without having both an adequate understanding of the products and the necessary internal controls.

67 Australian Securities Commission, *Report on Over-the-Counter Derivatives Markets*, May 1994.

68 Companies and Securities Advisory Committee, *Law of Derivatives: An International Comparison*, January 1995.

69 Companies and Securities Advisory Committee, *Regulation of the OTC Derivatives Market*, August 1995.

4.10 Although some efforts are being made to educate users of derivatives[70] the Committee remains concerned that users of these products, including executives and directors of Australian companies, managed funds, trusts and individual investors, may not be sufficiently aware of the potential hazards of using derivatives. Further efforts to educate the users of these products are essential. The Committee considers that more publicity needs to be given by the ASX, the SFE and the ASC to the possible risks involved in using derivatives and the need for corporations using these products to have adequate controls in place.

4.11 The Committee's final concern is that the superannuation savings of Australian workers may be placed at risk through derivative trading by fund managers. Although this issue lies outside of the Committee's direct area of interest it is gravely concerned by this possibility. The hearings conducted by the House of Representatives Banking, Finance and Public Administration Committee with the Insurance and Superannuation Commission have served to demonstrate that this issue is not being adequately addressed at this stage. The Committee believes that this is an issue which must be closely monitored. In the Committee's view the most appropriate parliamentary body to consider this area in a comprehensive, ongoing way is the Senate Select Committee on Superannuation.

STEPHEN SMITH, MP
CHAIRMAN

20 NOVEMBER 1995

70 The Sydney Futures Exchange, for example, conducts education programs for senior managers and directors and has produced booklets on derivatives entitled *Demystifying Derivatives* and *Surviving with Derivatives, What Directors need to Know.*

APPENDIX A

ADVISORY COMMITTEE
DERIVATIVES PANEL

MEMBERS

Bob Austin, Minter Ellison
Ralph Ayling, Minter Ellison
Brenda Berkeley, Federal Attorney-General's Department
Tricia Bowden, Citibank Ltd
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