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## FINANCIAL RISK HEDGING MECHANISMS

### Derivatives in the Australian Context

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#### INTRODUCTION

Schuyler Henderson's paper on the regulation of 'Swaps and Derivatives: How and Why?' does not extensively refer to the Australian scene, but people can be assured that most of the issues raised and discussed in the paper are relevant to Australia.

The purpose of my commentary is to outline the regulatory structure for derivatives in Australia so that Mr Henderson's comments can be put in context. In addition, there will be discussion of the current review of derivatives being carried out by the Australian Securities Commission. My initial comments are based on a Banking Law Association Special Report entitled 'Options: should they be regulated as futures contracts?'

#### MARKET PRACTICE

Traditionally a futures contract was a particular form of forward agreement traded on a futures exchange. Futures contracts traded on the Sydney Futures Exchange (SFE) developed in the following order:

- (i) deliverable agricultural futures contracts. On the SFE the first contract was a deliverable greasy wool contract that commenced trading on 11 May 1960;
- (ii) deliverable financial futures contracts. On 17 October 1979 the SFE commenced trading the 90 Day Bank Accepted Bill futures contract;
- (iii) cash settled currency contracts. On 19 March 1980 the SFE introduced a cash settled US dollar futures contract. The contract was the first cash settled contract in the world;
- (iv) cash settled futures contracts over indices. On 16 February 1983 the SFE commenced trading futures contracts over the Australian All Ordinaries Share Price Index;
- (v) options over cash settled futures contracts. On 18 June 1985 the SFE started trading options over the All Ordinaries Share Price Index. Options over the other futures contracts, which included deliverable futures contracts over commodities and financial instruments, quickly followed; and
- (vi) eligible exchange traded options (EETOs), that is essentially over-the-counter options (OTC Options) traded on the futures market of a futures exchange are scheduled to be introduced by the SFE in 1993. OTC Options are typically customised between the two parties and are non-fungible in contrast to the planned EETOs.

## MEANING OF FUTURES CONTRACT

There have been several cases which have considered the meaning of 'futures contract' at common law.<sup>1</sup> The position can be summarised as follows:

- (i) a futures contract is a particular form of forward agreement. The distinguishing characteristic of a futures contract is that of standardisation, or more correctly the characteristic of fungibility;
- (ii) a futures contract is a contract concerning commodities in the traditional sense and not financial instruments. This is understandable because financial futures only commenced trading in Australia in October 1979 and have only come to prominence since the 1980s;
- (iii) the facts of each case involved futures contracts over commodities and not financial futures; and
- (iv) the futures contracts were deliverable and not cash settled.

It is common to speak of 'buying' and 'selling' futures contracts. Technically however, the parties do not buy or sell contracts. Parties enter contracts to buy or sell commodities for future delivery (for deliverable commodity futures contracts).

## FUTURES CONTRACTS ARE FUNGIBLE

A futures contract is a particular form of forward agreement. The distinguishing features of a futures contract are standardisation and fungibility. These concepts deserve further analysis.

Standardisation means that an instrument conforms to a standard. For example, futures options have predetermined exercise prices, expiry dates, types of options (for example put or call) and the subject matter of the option is of a specified quality or grade.

Because futures contracts traded on an exchange are standardised it permits fungibility, that is, all futures contracts of a particular class are perfect substitutes for each other and obligations under a given futures contract are readily transferable through novation. Fungibility is the characteristic of interchangeability and is a distinguishing feature of futures contracts as it enables a futures contract to be used as a trading vehicle.<sup>2</sup>

Slade LJ in *SCF Finance v Masri*<sup>3</sup> understood that fungibility distinguishes a futures contract from other forms of forward agreement. Slade LJ's definition of futures contract should be refined because standardisation permits fungibility, and fungibility is the characteristic of interchangeability and just because an instrument is standardised does not mean that it is fungible.

Although not expressly referring to the concept of fungibility, the other judges did refer to 'closing-out' open futures contracts. The ability to close-out futures contracts is a by-product of them being fungible. I submit that the following is a more accurate description of a futures contract:

*'A futures contract is a standardised agreement to deliver or take delivery of a specified amount of a commodity of a given grade or quality, or to make a cash adjustment based on a change in the price of the commodity, at an agreed time in the future. The word "commodity" here includes financial instruments or indices.'*

## THE DEFINITION OF FUTURES CONTRACT IN THE CORPORATIONS LAW

The definition of futures contract in the *Corporations Law* is made up of four separate parts:

- (i) futures contract was defined to include an 'eligible commodity agreement.' Broadly speaking an eligible commodity agreement is a deliverable futures contract, which is a futures contract under

which physical delivery of the subject matter of the contract is possible (delivery is compulsory if the contract is held until the settlement day);

- (ii) futures contract was defined to include an 'adjustment agreement.' Broadly speaking an 'adjustment agreement' is a cash settled futures contract, which is a futures contract under which physical delivery of the subject of the contract is not permitted. The difference between the price paid upon opening the contract and the settlement price is paid in cash on the settlement day;
- (iii) futures contract was defined to include a 'futures option' which is an option or right to assume over an eligible commodity agreement or an adjustment agreement. In other words, it is an option over what are commonly referred to as futures contracts; and
- (iv) futures contract was defined to include an eligible exchange traded option (or EETO), which is an option over a prescribed index or commodity that is traded on a futures market of a futures exchange.

An instrument will not be a futures contract if it is an agreement that is a currency swap, interest rate swap, forward exchange rate contract or a forward interest rate contract to which a bank or merchant bank is a party. The exclusionary part of the definition is important.

The above broadly sets out the regulatory structure in Australia. On first glance you might think that Chapter 8, in particular, the definition of futures contract, is not about the regulation of derivatives in Australia. Unfortunately, this is incorrect. The definitions of 'adjustment agreement' and 'eligible commodity agreement' are extremely broad so that it is possible that some derivatives may be caught by the definitions.

Of particular significance is the definition of 'standardised agreement.' The concept of standardised agreement is used in both the definitions of adjustment agreement and eligible commodity agreement. Broadly speaking, a standardised agreement is one of two or more agreements of the same kind as each other. An agreement is of the same kind if and only if the provisions of the agreement are the same and not materially different from the first agreement disregarding:

- (i) the fact that the parties to the agreements are different; and
- (ii) any difference in the amounts payable under the respective agreements.

The crucial issue for derivatives is whether they are standardised within the meaning of Chapter 8. If they are there is a possibility that they are regulated as futures contracts. If an instrument is standardised consideration needs to be given to whether derivatives have the benefit of the exclusionary part of definitions of futures contract.

Because of the wide definition of standardisation and the case of **Carrageen Currency Corporation**<sup>4</sup> it became apparent that derivative products may be futures contracts within the meaning of Chapter 8. As a result several banks and investment banks requested that the over the counter products that they market be declared as 'exempt futures markets' to remove the uncertainty that now existed. Additionally, the Australian Securities Commission became concerned that several derivative products were filtering down to the retail level. Ultimately the Australian Securities Commission decided to review its exempt futures markets policy. The ASC Discussion Paper entitled 'Derivatives traded on Over the Counter Markets' was released in late January 1992. The ASC stated the review was likely to result in:

- (a) a draft policy to replace that part of NCSC Release 152 that deals with Exempt Futures Market declarations. Such a policy will, when finalised, be the basis of future advice provided by the ASC to the Minister in response to applications for exempt futures market status;

- (b) Identification of other issues raised by trading and derivatives, especially where those derivatives are traded off exchange; and
- (c) Recommendations for further policy analysis and development, including possible law reform initiatives.

#### **SUBMISSIONS TO THE AUSTRALIAN SECURITIES COMMISSION:**

Not surprisingly there is some divergence in opinion as to the most appropriate way in which to treat derivative markets. Because of the limitation of time I will only deal with the joint submission of Australian Bankers Association, Australian Financial Markets Association and the International Bankers and Securities Association joint submission and BZW's submission.

The conclusion in the joint submission provides an accurate summary of the position. The conclusion states:

##### ***'Conclusions***

*An appropriate regulatory response to the issues identified in the Commissions discussion paper must involve:*

- (i) *prompt reduction of uncertainty as to whether particular contracts can lawfully be entered otherwise than by being bought or sold on a futures exchange.*
- (ii) *recognition of the characteristics of off-exchange trading detailed in this submission.*

*Ideally, there should be legislative changes to re-define "futures contract" in terms which meet the original objective of covering only those contracts ordinarily regarded as futures contracts.*

*However, the above-mentioned uncertainty should not be permitted to continue. Accordingly, every effort should be made to achieve this result by speedier means than legislation. There is adequate regulation-making power. Pending any legislative changes which might ultimately be made, we recommend the following:*

- (i) *A regulation should be made, in addition to the existing exclusions under Section 72(1) (d) of the Corporations Law, excluding from the definition of futures contract, any contract which satisfies the following criteria:*
  - *the contract does not form part of a class of contracts that are both standardised as to their material economic terms and fungible; and*
  - *one party to the contract is an "approved financial institution" and the other party is either an approved financial institution or an "appropriate person".*
- (ii) *For the purposes of this regulation, "approved financial institution" should include:*
  - *locally regulated financial institutions (eg banks, life companies, building societies, credit unions, authorised money market dealers) and comparably regulated overseas institutions (eg OECD banks);*
  - *guaranteed subsidiaries of "approved financial institutions";*
  - *other highly rated entities and adequately capitalised licensed securities dealers and futures brokers;*

- *such other entities as are approved by the Commission.*
- (iii) *"Appropriate person" should be defined along the lines of either the US exemption for swaps or other comparable exemptions from securities or futures regulation directed at categorising those persons who are deemed to have sufficient means or sophistication to appreciate the nature of any risks being undertaken.*
- (iv) *The only scope for exempt futures market declarations would be where an applicant did not satisfy the terms of the regulation but was able to satisfy the Minister that, in respect of a particular product, an exemption should nevertheless be granted. It is envisaged that applications might be, for example:*
  - *from an "approved financial institution" in respect of a product made available to retail clients (ie persons who do not qualify as appropriate person); or*
  - *from an "appropriate person" (not being an approved financial institution) in respect of a product which is only made available to other "appropriate persons".*

I agree with the conclusions of the submission but believe there are also other issues which are canvassed below. The following is an edited version of BZW's submission to the ASC.

#### **SUGGESTED APPROACH**

The review needs to be divided into two distinct parts. First, the Australian Securities Commissions (ASC) policy concerning the granting of 'exempt futures market' status under the *Corporations Law*. The second needs to address the underlying definitional problems highlighted below.

An interim solution for the first problem is to focus on the entities dealing and draft a 'safe harbour' style exemption for over the counter derivatives. BZW has participated in and agrees with the joint proposal submitted by the ABA, AFMA and IBSA on the industry's behalf.

While it is appropriate for the ASC to handle the exempt futures markets policy it is BZW's view that the underlying definitional problems are best dealt with by the Companies and Securities Advisory Committee.

#### **WHAT IS BEING REVIEWED?**

To understand properly and resolve the problems the issues must be clearly defined. It is difficult to define what a derivative is because derivatives include many different instruments including futures contracts, share options, futures options, swaps, caps, collars, floors, etc.<sup>5</sup> However, industry problems arise in four general areas:

- Options;
- Forward agreements;
- Swaps; and
- Hybrid instruments.

The problems facing each type of instrument are different and the review process must address this. For example, the main issue concerning options is: Are options futures contracts at all? If so, should they be traded on a futures exchange?

In contrast, hybrid instruments may exhibit the characteristics of a security and a debt instrument. One important issue is whether to regulate the instrument as a security or as a debt.

## CONFUSING OBJECTS OF THE REVIEW

The Discussion Paper's main focus is the ASC's policy on granting exempt futures markets under section 1127 of the *Corporations Law*.<sup>6</sup> While this is the main object, clearly the ASC recognises that there are fundamental problems underlying the review of its exempt markets policy. Problems that cannot and should not be resolved in the period allowed.

The problems concerning exempt futures markets are merely a manifestation of underlying fundamental definitional problems with the *Corporations Law*.

## INTERRELATIONSHIP OF MARKETS

The Discussion Paper states, almost without exception, that many derivatives are 'futures contracts' regulated by the *Corporations Law*. This is not so.<sup>7</sup> Futures markets and the over the counter markets are distinct.

Over the counter markets have certain characteristics in common with futures markets, but many differences. For example, futures markets offer highly standardised contracts<sup>8</sup> whereas derivatives are tailored or customised to specific particular risks or needs.

This is not to say that derivatives are unique in all respects. They are not. The adoption of certain boiler plate clauses from ISDA does not mean that the instruments become 'futures contracts' within the meaning of the *Corporations Law*. The material elements of the instrument are still negotiated.

An important function of the ISDA terms is to give certainty and importantly allow more effective risk management by permitting a common basis of risk assessment for over the counter trades. A trend towards standardising some documentation has occurred to:

- Reduce misunderstandings as to terminology;
- Improve efficiency in handling paper work between parties;
- Improve the processing of trades;
- Facilitate the development of a secondary market; and
- Add liquidity.<sup>9</sup>

Moreover, growth in over the counter markets has not taken volume from futures exchange. In fact, the opposite is the case. Over the counter markets have led to an increase in futures exchange volumes.<sup>10</sup> If a corporation takes on an unacceptable risk by entering into a derivative it is common practice to hedge that risk by backing it onto the futures market.<sup>11</sup>

The role of each market also differs. It is accepted that securities and futures markets have a price discovery role in the economy. This is one reason why it is a serious offence to manipulate a share or futures market and distort the price discovery mechanism. Derivatives markets do not have the same function. One function of derivatives is to provide prices for those entering into the instrument. Pricing is determined by reference to the physical and futures markets.<sup>12</sup> Derivatives, because they are tailored, are not homogeneous and therefore they serve no price discovery mechanism. Issues of manipulation are therefore only marginally relevant to the derivatives market.

## OVERREACTION AND OVER REGULATION

It is troubling that the ASC fails to understand the purpose and role of the derivatives market in Australia and overseas. Any regulation must be appropriate to the market, otherwise to regulate is to exterminate the market. The Discussion Paper proceeds on a premise that the market is one involving the general

investing public and any regulation should be decided accordingly. This is not so. Derivatives markets are primarily institutionally based. The products are complex and this will restrict the filtering down of these instruments to the retail level. Participants are restricted to those with high credit ratings. The *Financial Review* on 10 February 1993 (republishing an article from the *Wall Street Journal*) noted:

*'A stellar credit rating is crucial in the derivatives markets: many multinational corporations won't deal with Wall Street dealers with lower than triple-A ratings ...'*

The review must identify who are to be protected and why. It is not acceptable to impose retail forms of regulation on an institutional market.

To do so will:

- Stifle innovation;
- Reduce competition;
- Increase costs for Australia's financial institutions and fund managers, resulting in an increase in the cost of finance effect to the general public;
- Send business overseas; and
- Increase risk by depriving institutions of the opportunity to individually tailor cover for specific risks.

The failure to clarify the law will also be detrimental. Wendy Gramm on 9 November 1992 while still Chairman of the Commodity Futures Trading Commission (CFTC) when discussing the exemption for swaps<sup>13</sup> and hybrid from CFTC regulation stated:

*'The swap's exemption will eliminate legal and regulatory uncertainties that could have become a major deterrent to market growth in the US.'*

She continued:

*'Do those seeking re-evaluation and possibly curbs on the use of these instruments have any jurisdictional or competitive axes to grind? I hope the studies will be careful and analytic. I hope they will not be used to impede competition and hinder innovation - all in the name of "customer protection" or "market integrity", of course.'*

She concluded:

*'... no matter how loud the chorus for tinkering with market pricing mechanisms, I remain unconvinced that government intervention in these markets is necessary, appropriate or ultimately effective.'*

Phillip McBride Johnson, a former Chairman of the CFTC, as early as January 1985 stated:

*'... the truth is that the "public" does not patronise the futures markets in the first place - that comes for (sic) commercial users and professional traders.'*<sup>14</sup>

Pen Kent an Associate Director of the Bank of England on 1-2 December 1992 stated:

*'... the financial derivatives markets have on balance reduced rather than increased risk ... to meet a demand for a way of coping with the world of floating exchange rates, floating interest rates and volatile inflation rates.'*<sup>15</sup>

In conclusion, the ASC must appreciate that treasury operations are now being established and operated on a global basis. The treasury operations in each country do not act independently, but as part of a global network. Therefore regulatory issues cannot be considered in isolation but their global impact must be considered and assessed.<sup>16</sup>

#### DISCUSSION PAPER PROCEEDS ON FALSE PREMISE

Often the Discussion Paper makes bold, broad ranging and inaccurate statements about the derivatives markets. For example on page 9 it states:

*'The manner in which many providers of over-the-counter derivatives facilities now market their products means that it is highly likely in almost all cases they will be conducting a "futures market" ...'*

This statement is neither true in fact nor law. The problem with derivatives is not that they are all regulated, but rather uncertainty if they are regulated.

The manner in which a product is marketed is not relevant in determining whether the instrument is a futures contract under the *Corporations Law*.<sup>17</sup>

It is unfortunate that this paragraph is only an example of the failure of the ASC to understand the nature of derivatives and over the counter markets.

#### CONCLUSION

There is no doubt that there are interesting times ahead in Australia in the area of derivatives regulation. Schuyler Henderson's paper helps map out the type of problems and it is hoped this commentary assists in putting those problems within an Australian context.

#### FOOTNOTES

1. A full list of cases can be found on page 2-3 of 'Options: Should they be regulated as futures contracts?', 1992, Banking Law Association Special Report.
2. Hains, M G, 'FRAs, Swaps, Futures, Options and the Concept of Standardisation', (1990) 4 *JIBFL* 158.
3. [1986] 2 *Lloyds Law Reports* 366.
4. (1987) 7 *NSWLR* 705.
5. The term derivative is a chameleon and has many meanings. For example, it is used in the context of a Shareholders Statutory Derivative Action, or means a futures contract or some other financial or commodity based instrument.
6. ASC Discussion Paper, 'Derivatives Traded on Over the Counter Markets', 1993, at 3.
7. See further discussion below.
8. More correctly futures contracts are fungible. See Hains M G, 'FRAs, Swaps, Futures, Options and the Concept of Standardisation', (1990) 4 *JIBFL* 158.
9. See Hains M G, 'FRAs, Swaps, Futures, Options and the Concept of Standardisation', (1990) 4 *JIBFL* 158 at 164.



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10. Wendy Gramm, Speech to the ISDA North American Regional Conference, Washington DC, 9 November 1992.
  11. This can be a complicated process and the entity will have to create a 'synthetic' futures position to reproduce the risk profile of the derivative.
  12. Pricing will vary depending on the type of derivative market concerned.
  13. The phrase 'swap' is defined in the *Futures Trading Practices Act* 1992 in wide terms and includes, commodity swaps, caps, collars, floors, etc. See also H Rep No 102-978, 102nd Cong, 2nd Sess 81 (1992).
  14. 'Future Shock: Proposals for the Regulation of Futures Trading', BLEC Seminar, 31st January 1985.
  15. *Risk Magazine*, Vol 6 No 1, January 1993 at 26. Although contrary views were expressed by some regulators.
  16. See for example Crapp H, 'Controlling Global Treasury Risk', *Decisions*, February 1993, Vol 5 No 1.
  17. Except to the extent to which marketing may mean an instrument may need to be standardised.