

CAPITAL MARKETS - RISK MANAGEMENT PRODUCTS (PRACTICALITIES, DEVELOPMENTS AND PROBLEMS)

QUESTIONS AND ANSWERS

Question - Michael Hains (Ebsworth & Ebsworth, Sydney):

A question for Ted Kerr. With the increasing standardisation of documents heading towards ISDA documents, what sort of problems do you perceive with the definition of standardisation under Chapter 8 of the Corporations Law which is central to the definition of futures contracts because if an agreement is standardised and otherwise satisfies the definition then the instrument will be a futures contract and of course a principle underlying Chapter 8 is that all futures contracts must be traded on the futures market of a futures exchange?

Response - Ted Kerr (Speaker):

Thank you Michael. It is obviously a very difficult question. Chapter 8 of the Corporations Law has the definition there of futures contracts which has caused lawyers a lot of anguish. The definition of standardisation though does not only depend on the actual wording of the master agreement, it also depends on the economic transaction which is taking place. Of course it was always the intention of Chapter 8 that it was dealing with standardised contracts in the sense that you had a standardised amount of notional principal, a standardised settlement date, and all those types of features. Now in the contracts that have been dealt with in the markets, not on the futures exchange, obviously every contract had its own peculiar economic features and you can mount a strong argument that that takes it out of the standardisation. I do not say that it is absolutely certain and it is certainly an issue which I and a number of other lawyers have been saying for a long time that we need to get Chapter 8 sorted out. And the way to sort it out is not to give some more exemptions to the definitions of futures contract, but I believe you have to go to the type of safe harbour concept where you say the wholesale market should not be regulated, they are big boys, they should know what they are doing, but you do regulate the retail market. This is an issue I know is before the ASC - the ASC is considering it at the moment, but quite frankly it is an issue which has been difficult to get the banks to get all that keen about, but I just have a touch of a concern that it could suddenly leap up and bite us all.

Comment - Michael Hains (Ebsworth & Ebsworth, Sydney):

It is already biting someone but in a different context! I understand what you are saying, but one of the problems I have with that is that the essential argument is that it needs to be standardised for certain things such as contract size. Those precise issues were actually with the Attorney-Generals at the time the Futures Industry Code, which was the predecessor to Chapter 8, was being drafted. I read a number of the submissions made by the various parties who were saying that the concept of standardisation under what is now the Corporations Law should be for specific things such as contract size, maturity

dates and that sort of thing and that was not taken into consideration in the concept of standardisation. The problem I see is that the concept of standardisation is wrong in the context of futures contracts. Futures contracts are just one type of forward agreement and I think that really what distinguishes a futures contract from other forward agreements is not simply standardisation, but one step more and that is the characteristic of fungibility, which is the ability to interchange them. And of course that is the characteristic of a futures contract on the futures exchange - you can open it one day, come to the market the next and close it out, close them out or net is probably the wrong word in the context of here, and off he goes, whereas that is not always the case with a forward agreement.

Response - Hernan Gonzalez (Speaker):

If I can make just one observation about that. I think one of the reasons why fungibility exists in futures contracts is precisely because it is standardised and not just a contract but the market as a whole. You get to a certain settlement date and whether you want to or not, you are out, you get closed out. And I think that is an important distinction. I think the analysis of standardisation does, in my view, give you some significant differences between exchange traded regulated futures contracts and the products that we have been talking about.

Comment - Michael Hains (Ebsworth & Ebsworth, Sydney):

Except that one of the judges in one of his leveraged currency cases virtually said that anything more than two contracts is standardised which causes real problems!

Response - Hernan Gonzalez (Speaker):

Criticising judges has been somewhat in vogue at this conference!

Comment - Glen Smith (Chairman):

I have received a number of urgent hand signals from Fay Stewart at the back to break for lunch - so I had best comply with them and draw things to a close. Ken Farrow mentioned the AFMA Conference which is coming up later in the year. Presumably that conference is going to be well attended by dealers, and bearing in mind his remarks that they had a 15 minute attention span, spoke in grunts or at best monosyllables, it sure sounds like a great conference to attend! I am sure that having heard our three speakers, we all have a better understanding of the operation of risk management products in the capital markets area and I would like on your behalf to express thanks to our three speakers and I would like you to join me in thanking them in the usual manner.