

# Regulatory Reform of the Australian Over-The-Counter Derivatives Market

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*The Australian Companies and Securities Advisory Committee recently recommended a raft of changes to the regulation of derivatives in Australia. This article critically examines the proposal to extend statutory regulation to the over-the-counter derivatives markets. It explains why the introduction of statutory rules is not the most appropriate regulatory approach and suggests that a non-statutory regulatory regime be adopted instead.*

## Introduction

The global over-the-counter ("OTC") derivatives markets have generally operated without any rules. However, the rapid growth of OTC derivatives in the 1970s soon attracted the notice of financial regulators. Concerns about a derivatives-led market collapse were first voiced by New York Federal Reserve Bank Chairman, Gerald Corrigan, as early as 1992.<sup>1</sup> But, it was not until 1994 that the regulatory spotlight was focussed on the OTC markets. In that year, several counterparties in the United States ("US") sustained massive losses trading in OTC derivatives. Large institutional investors such as Gibson Greetings, Procter & Gamble, and Orange County, California, to name a few, lost heavily as a result of a general rise in US interest rates.<sup>2</sup> These derivatives-induced disasters were not confined to the US and a number of other markets were also affected.

The negative publicity surrounding derivatives eventually led to calls for the introduction of regulatory controls, not only in the

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<sup>1</sup> See Cullen, I, "The Development of Regulation of OTC Derivatives Business", in Swan, E J, (ed), *Derivatives Instruments Law*, Cavendish Publishing Limited, London, 1995, p 1.

<sup>2</sup> See Henderson, S K, "Derivatives Litigation in the United States" in Bettelheim, E, Parry, H, and Rees, W, (eds), *Swaps and Off-Exchange Trading: Law and Regulation*, FT Law & Tax, London, 1996, Chapter 9, for a discussion of these cases.

US but also in other countries like Australia. In mid-1994, the Australian Companies and Securities Advisory Committee ("CASAC") commenced its review of derivatives, following the release of the Australian Securities Commission's *Report on Over-the-Counter Derivatives Markets* in May 1994. Although the Australian OTC derivatives market had not suffered any major setbacks, the regulatory authorities nevertheless felt that there was a cogent need to introduce some regulatory initiatives which would further promote its reliability and stability.<sup>3</sup> In June 1997, CASAC released its final report on the review of derivatives, which, among other things, proposed widespread changes to the regulation of the on-exchange and OTC markets.<sup>4</sup>

One of the main thrusts of CASAC's recommendations is the extension of statutory regulation to the Australian OTC markets. This article will analyse the regulatory approach recommended by CASAC, assess the feasibility of adopting statutory rules to regulate the OTC markets, and consider alternative approaches to regulation. It begins by examining the nature of derivatives and the risks they pose. Then, it outlines the main recommendations proposed by CASAC. Finally, it evaluates the regulatory approach recommended by CASAC. It concludes that the introduction of statutory rules is not the most appropriate regulatory approach and suggests that a voluntary code of practice be adopted instead.

## Derivatives : An Overview

### Introduction

Although there is evidence which suggests that derivatives, such as futures contracts, have been around for a while, it was not until the early 1970s that derivatives gained widespread acceptance and usage.<sup>5</sup> The collapse of the Bretton Woods agreement in 1971 and the oil crisis sparked by the oil embargo of 1973 led to increased volatility in commodity prices, interest and currency rates on a global scale. This in turn led to the development of swaps, futures contracts and options constructed around interest rates, currencies and physical

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<sup>3</sup> See CASAC, *Regulation of the OTC Derivatives Market*, Discussion Paper, Sydney, August 1995, p 9.

<sup>4</sup> CASAC, *Regulation of On-Exchange and OTC Derivative Markets*, Final Report, Sydney, June 1997 [hereinafter referred to as "CASAC Report"].

<sup>5</sup> See, for example, LaPlante, J D, "Growth and Organisation of Commodity Markets", in Kaufman, P J, (ed), *Handbook of Futures Markets*, Wiley, New York, 1984, for an account of the early history of futures.

commodities. These instruments, which were originally developed for hedging purposes, were soon used for an array of purposes, including the enhancement of yields, the lowering of finance costs, and the restructuring of investment portfolios.<sup>6</sup> They were particularly attractive to investors because of the leverage that they permitted. For example, the initial outlay for the purchase of a futures contract could be as low as five per cent of the total investment. This makes it possible for investors to enjoy significant gains from a small investment.

### Nature of Derivatives

The term 'derivatives' has no legal meaning ascribed to it in Australia, although various bodies and committees have adopted their own working definitions.<sup>7</sup> Currently, there is no requirement for a legal definition since derivatives are regulated under the *Corporations Law*, depending on whether they are 'futures contracts' or 'securities'.<sup>8</sup> Although the statutory definition of futures contract covers options, it excludes many other categories of derivatives such as forward contracts and swaps.<sup>9</sup> It is important for the purpose of this article to explain the nature of derivatives, as an understanding of derivatives is a prerequisite for any meaningful discussion of the reform proposals recommended by CASAC.

A derivative may simply be defined as a financial instrument whose value fluctuates according to the value of an asset, instrument, index or reference rate. For example, the value of a futures contract involving the delivery of a fixed quantity of wheat at an agreed future date, varies with the price of that particular grade of wheat on the physical market. When the price of wheat on the physical market falls, the value of the futures contract also falls. Naturally, such a broad definition of derivatives is capable of encompassing a wide range of financial

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<sup>6</sup> See, for example, Das, S. *Swaps and Financial Derivatives*, (2nd ed), The Law Book Co, Sydney, 1995, for a detailed discussion of the commercial uses of OTC derivatives.

<sup>7</sup> See, for example, the definitions of derivatives found in CASAC, *Law of Derivatives: An International Comparison*, Sydney, January 1995, p 1; and Global Derivatives Study Group, *Derivatives: Practices and Principles*, Group of Thirty, Washington DC, July 1993, p 28 [hereinafter referred to as "G 30 Report"].

<sup>8</sup> Currently, Chapter 8 of the *Corporations Law* applies to futures contracts, while Chapter 7 applies to securities. See also ss 72A and 92A which allow instruments that exhibit elements found in both futures contracts and securities to be regulated on a more flexible basis.

<sup>9</sup> See *Corporations Law*, s 72(1).

instruments. Even a residential mortgage, whose interest rate is predicated on the inter-bank offered rate, could qualify as a derivative using the above definition.

Generally, derivatives contain one or both of the following elements:

- a forward element, which involves an obligation to deliver the underlying asset or to make a cash adjustment (based on the difference between the agreed price and the price at the time of settlement) in the future;
- an option element, which involves the right to buy or sell the underlying asset at an agreed price in the future.<sup>10</sup>

### Types of derivatives

There are several ways of classifying derivatives. For example, it is possible to classify them according to the nature of their underlying asset. Under this approach, derivatives based on equities and share indices are referred to as equity derivatives, and those based on physical commodities, as commodity derivatives. However, the more popular but traditional approach is to divide derivatives into specific product categories such as forward contracts, futures contracts, swaps or options. Apart from these four main product types, there is yet another category of derivatives which for want of a better term is referred to as hybrid instruments. Hybrid instruments are essentially instruments which exhibit features found in more than one type of derivative, or securities and debt instruments with embedded derivative features. An excellent example of a hybrid instrument is a 'swaption' which is basically an option over a swap. Another example is the share ratio contracts traded on the Australian Stock Exchange.

Derivatives that are traded on exchanges are referred to as exchange-traded derivatives, while those traded off-exchange are referred to as OTC derivatives. OTC derivatives, unlike exchange-traded derivatives, are bilateral contracts whose terms are individually negotiated. They are essentially customised products designed to meet the specific needs of the counterparties. Despite the increasing use of standardised

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<sup>10</sup> See CASAC Report, already cited n 4, p 17.

documentation like the International Swap and Derivatives Association contract, the economic terms of these transactions (such as the commodity grade, payment term, and delivery date) remain non-standardised. Since OTC transactions are not traded on organised exchanges they are therefore not subject to any margining requirements. Neither are there clearing houses to secure performance of these contracts. Although some counterparties collateralise their obligations, credit risk is generally more significant in OTC transactions. Most OTC market participants enjoy strong credit ratings as it is unlikely that a financially weak party would be able to transact in the OTC markets. It is therefore hardly surprising that in Australia, banks and merchant banks are the most active participants in the OTC market.<sup>11</sup>

A wide category of financial instruments would fall within the rubric of 'OTC derivative'. They not only include swaps, forward contracts and options, but also derivative securities and collateralised mortgage obligations. In Australia, the more popular OTC products are forward rate agreements, interest rates and cross-currency swaps, bond options, caps, floors, and currency options.<sup>12</sup> The OTC market is very large but it is difficult to accurately determine its size as statistical information is still lacking. According to the Reserve Bank of Australia, as at end March 1995, OTC business in Australia accounted for all activity in foreign exchange derivatives and 58 per cent of interest rate derivatives activity.<sup>13</sup> Since the notional principal amounts outstanding were US\$581.1 billion for foreign exchange derivatives and US\$597.5 billion for interest rates derivatives, it would appear that the Australian OTC market is a relatively large one.<sup>14</sup>

### Risks Posed by Derivatives

It is paradoxical that although derivatives were originally developed to manage risks, they themselves give rise to a plethora of risks. Basically, there are four broad categories of risks that both dealers and end-users of derivatives are usually subject to: market risk, credit risk, operations risk, and legal

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<sup>11</sup> See Australian Securities Commission, *Report on Over-the-Counter Derivatives Markets*, Melbourne, May 1994, p 12.

<sup>12</sup> *id.*, p 13.

<sup>13</sup> Phelps, L, *Current Developments in Prudential Supervision*, Address to the 1996 Banking Industry Congress, February 1996, Sydney, p 12.

<sup>14</sup> *id.*, p 11.

risk.<sup>15</sup> Briefly, market risk is the risk of losses arising from adverse market movements, such as changes in interest rates, foreign exchange rates and commodity prices. Credit risk is the risk that a counterparty may fail to meet its obligations. OTC participants are exposed to credit risk to a much greater extent than exchange participants. In most exchanges, the clearing house guarantees performance of registered contracts. Hence the credit risk for exchange-traded contracts is less than for OTC contracts. Operations risk is the risk of losses arising from inadequate systems, human error, fraud or management failure. The collapse of Barings, to a large extent, stemmed from the lack of proper systems of control and management failure. Legal risk results from exposure to the possibility that a court of law or legislative body may invalidate a derivative contract. For example, in *Hazell v Hammersmith and Fulham London Borough Council*<sup>16</sup> the English House of Lords upheld the decision at first instance that local authorities had no power to enter into swaps. As a result the local council in question refused to make any further payments on its existing swap contracts.

It should be recognised that these four main types of risks are not unique to derivatives as they are found in other traditional financial products as well. But, there are a number of factors which probably make derivatives more risky than other financial instruments. First, being more complex in nature, they lack transparency and are harder to manage. Second, they have a much more rapid risk transformation profile than conventional financial products. An investor can lose substantial sums of money within a very short space of time if there is any adverse market movements. Third, derivatives by their very nature are highly leveraged products. Investors stand to gain large sums of money if the market moves favourably. By the same token, they stand to lose substantially if the market moves adversely. Notwithstanding the fact that derivatives are inherently more risky than other financial products, it is submitted that if used properly they pose no greater risk than the underlying investment. For example, derivatives pose little risk if used only for hedging purposes. But, they pose substantial risk when used for speculative purposes.

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<sup>15</sup> See G 30 Report, already cited n 7, for a detailed treatment of the risks involved in derivatives transactions.

<sup>16</sup> [1992] 2 AC 1.

## Proposed Regulatory Reform

### Introduction

For number of years, OTC derivatives in Australia and elsewhere have been left in what has been described as a state of “benign regulatory neglect”.<sup>17</sup> There are a couple of reasons for this state of affairs. First, the global OTC markets have since their inception operated largely on a *caveat emptor* basis, and they have not been the worse off for that. Second, since most wholesale participants were (and still are) predominantly financially sophisticated institutions, they saw no need for any regulatory intervention. However, as reports of losses in the OTC markets surfaced in 1994, regulators everywhere began to doubt whether sophisticated investors were actually capable of safeguarding their own interests. Some losing counterparties themselves felt that some form of regulatory controls may be needed.

But, is it really true to say that OTC derivatives are not subject to any form of regulatory controls? The answer is no, because if one of the parties to an OTC transaction is a regulated entity, then arguably the transaction is subject to some form of regulation. Since banks are the main OTC participants and they are regulated by the Reserve Bank of Australia, it would then follow that a significant portion of OTC activities in Australia are subject to some form of regulation. Why then the need for extending regulation to the Australian OTC markets? To answer this question we need to examine the underlying concerns of CASAC.

### Background to Regulatory Reform

On 25 June 1997, CASAC presented its Final Report on *Regulation of On-exchange and OTC Derivatives Markets* (“CASAC Report”) to the Federal Treasurer, the Honourable Peter Costello MP. In its report, CASAC saw the principal purpose of regulating the derivatives markets as “ensuring that they work efficiently and equitably, while remaining globally competitive.”<sup>18</sup> To achieve this goal it recommended a number of legislative initiatives that would result in the following:

- authorisation of markets;

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<sup>17</sup> See Henderson, already cited n 2, p 282.

<sup>18</sup> CASAC Report, already cited n 4, p 29.

- licensing of intermediaries;
- introduction of safeguards for investors; and
- regulation of market behaviour.

The assumption implicit in the above recommendations is that the OTC markets are unlikely to be able to function efficiently or fairly without some form of statutory regulation.

### Current Regulatory Position

Before proceeding to outline the various proposals suggested by CASAC, it would be necessary to explain why the existing *Corporations Law* only covers a limited range of derivatives. The answer lies in the fact that the provisions of Chapter Eight were designed to apply only to agreements that fall within the definition of 'futures contract'.<sup>19</sup> This definition is limited in scope and covers four main species of derivatives: eligible commodity agreements; adjustment agreements; futures options; and eligible exchange-traded options.<sup>20</sup> Furthermore, currency swaps, interest rate swaps, forward exchange rate contracts, and forward interest rate contracts, to which an Australian bank or merchant bank is a party to, are excluded from the definition. As a consequence, there is a significant number of categories of derivatives that are not subject to the provisions of Chapter 8. Apart from excluded contracts, the derivatives that are not regulated include, those traded off-exchange, and those which fall outside the definitions of 'futures contract' and 'security'.

### OTC Market Authorisation

Under the proposed regulatory regime, no person is allowed to conduct a derivatives market unless authorised.<sup>21</sup> Although the term 'derivatives market' will probably cover almost all types of derivatives activities, they will only be regulated as a market where the Australian Securities Commission ("ASC") determines that the public interest is served by doing so. As the current *Corporations Law* does not contain any definition of

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<sup>19</sup> See *Corporations Law*, s 72(1).

<sup>20</sup> See *Corporations Law*, s 9, for their definitions. See also, Hains, M, "Futures Contracts: Do They Include Forwards and Swaps?" in Walker, G, and Fisse, B, (eds), *Securities Regulation in Australia and New Zealand*, Oxford University Press, Auckland, 1994, for a criticism of the existing futures contract definition.

<sup>21</sup> CASAC Report, already cited n 4, Appendix 1, recommendation 7.



'derivative', it would be necessary to introduce one which would be capable of covering both on-exchange and OTC derivatives.<sup>22</sup> Any person who applies to be authorised as a OTC derivatives market is required to show that the market will be conducted in a fair and orderly manner.<sup>23</sup> However, CASAC has not spelled out what the general authorisation criteria would be. The ASC will have appropriate powers to ensure the fair and orderly conduct of OTC derivatives markets. Surprisingly, there is no general obligation on the part of OTC markets to provide contract protection mechanisms like novation clearing for controlling counterparty credit risk.<sup>24</sup>

### Licensing of Intermediaries

The proposed licensing scheme prohibits persons from carrying on a business, or holding out that they carry on a business, in Australia, of dealing in any OTC derivatives contract on behalf of another person, unless they are licensed to act as a broker in the OTC market.<sup>25</sup> This prohibition extends to the arranging for one person to enter into an OTC derivatives contract with another person. OTC market-makers, regardless of whether they deal with wholesale or retail end-users are also required to be licensed.<sup>26</sup> (A market maker is a person who is engaged in the business of both structuring and entering as principal, into either, or one side of an OTC transaction with an arm's length end-user.) Two classes of market-makers will be exempt from licensing: entities regulated by the Reserve Bank of Australia; and any other market maker whose risk management system and capital standards are appropriately supervised by another regulator or SRO.<sup>27</sup> In addition, the ASC is empowered to exempt certain end-users whose activities may constitute market-making from licensing.<sup>28</sup>

Similarly, the proposed licensing scheme prohibits persons from carrying on a business, or holding out that they carry on a business, of advising on OTC derivatives transactions, unless they are appropriately licensed.<sup>29</sup> CASAC supports the existing approach of exempting from licensing, media advisers and those involved in the provision of incidental advice, such as

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<sup>22</sup> id, recommendation 4.

<sup>23</sup> id, recommendation 8.

<sup>24</sup> id, recommendation 12.

<sup>25</sup> id, recommendation 20.

<sup>26</sup> id, recommendations 21, 22.

<sup>27</sup> id, recommendation 21.

<sup>28</sup> id, recommendation 23.

<sup>29</sup> id, recommendation 24.

solicitors and accountants. CASAC also agrees that it would be inappropriate for fund managers, treasury operations and trustee corporations to be licensed.<sup>30</sup> The criteria for approving OTC brokers differ from that for approving market makers. It is proposed that the licensing criteria for OTC brokers will generally be the same as that for on-exchange brokers, although there will be no requirement for them to be members of a self-regulating organisation ("SRO"). Although, all market makers will be required to satisfy the prudential criteria for approval, those involved in the retail derivatives market will also be required to satisfy the competence and integrity criteria.<sup>31</sup>

### Prudential Regulation

OTC market makers will be required to satisfy the ASC that they have in place minimum satisfactory risk management systems for their derivatives transactions.<sup>32</sup> The ASC will be empowered to conduct surveillance to verify that these systems exist and operate in the way described by the market makers. If the licensees no longer have such systems, the ASC may suspend and if necessary revoke the licenses. OTC market-makers (other than RBA regulated entities and other exempt OTC market-makers) will also be required to satisfy the ASC that they meet minimum capital standards applying to all their derivatives trading activities.<sup>33</sup> As in the case of risk management systems, the ASC is empowered to verify that these minimum capital standards are met. Where they are not, the ASC may either suspend or revoke the licenses of the market-makers.

### Statutory Obligations

OTC brokers, market-makers and advisers will be subject to a number of statutory obligations, similar to those imposed on on-exchange brokers. Some of these obligations may be waived or varied for wholesale clients. Wholesale participants include the following categories of persons:

- all persons classified as wholesale in ASC Policy Statement 121;

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<sup>30</sup> id, recommendation 25.

<sup>31</sup> id, recommendations 21, 22.

<sup>32</sup> id, recommendation 26.

<sup>33</sup> id, recommendation 27.

- all listed companies;
- related companies of listed companies that opt to be treated as wholesale end-users by board of directors' resolution; and
- large proprietary companies.<sup>34</sup>

The key statutory obligations imposed on licensees are as follows:

First, all intermediaries will be required to enter into client agreements (that have minimum standard provisions) with their retail clients at the outset of their legal relationship.<sup>35</sup>

Second, they will be required to give a generic risk disclosure to retail end-users and eligible wholesale clients at the outset of the professional relationship or before accepting them as counterparties.<sup>36</sup> Retail end-users must acknowledge that they have received, read and understood the statement. However, corporate wholesale clients may waive their rights to receive such statements by a resolution of their board of directors. Failure to provide a risk disclosure statement is an offence and civilly liable in damages for any losses attributable to that failure.

Third, OTC derivatives advisers who make personal recommendations to retail clients are subject to a 'know your client rule'.<sup>37</sup> In other words, they are required to have regard to the information they have about their clients' investment objectives, financial situation and particular needs when making recommendations. Where the information is insufficient they must make reasonable inquiries. Additionally, they must conduct reasonable investigation and product research about the securities recommended. Advisers who breach this rule may be civilly liable to damages for any loss attributable to that breach.

Fourth, brokers who enter into OTC transactions are required within a stipulated period to provide their clients either with a copy of the contract document or contract note setting out the

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<sup>34</sup> id, recommendation 1.

<sup>35</sup> id, recommendation 28.

<sup>36</sup> id, recommendation 29.

<sup>37</sup> id, recommendation 31.

essential details.<sup>38</sup> They are also required to send monthly statements where any assets is held for the client during that period, or any money is paid out or received under any OTC contract by the broker as agent for the client, or any fee is charged by the broker.<sup>39</sup>

Fifth, OTC derivatives brokers are required to hold the funds of their clients separately from their own funds in a trust account.<sup>40</sup> Likewise, they are required to hold the property of their clients separately from their own assets.<sup>41</sup> This requirement extends to a party to any OTC derivatives transaction who receives deposit or margining funds, or property to secure deposit or margining obligations, unless both parties are wholesale participants and the terms of the transaction or Master Agreement stipulate some other arrangement.

Sixth, OTC derivatives brokers are required to keep records of the orders received and transactions made on behalf of their clients for seven years.<sup>42</sup> Market-makers are also required to keep records of their transactions for a similar period.

Finally, OTC licensees will be prohibited from operating a discretionary account on behalf of an OTC retail end-user without an appropriate written and signed client agreement.<sup>43</sup> Those who operate discretionary accounts (for both wholesale and retail clients) must have reasonable grounds for believing that any transactions which they effect or arrange are suitable in view of the facts known, or should reasonably be known, about the client's personal or financial situation.<sup>44</sup>

#### Investigative and Enforcement Powers of ASC

The recommendations made by CASAC aimed at regulating market behaviour and providing the ASC with broad investigative and enforcement powers are as follows:

First the ASC will have powers to control undesirable advertising; misleading or deceptive conduct; and cold-calling,

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<sup>38</sup> id, recommendation 34.

<sup>39</sup> id, recommendation 35.

<sup>40</sup> id, recommendation 38.

<sup>41</sup> id, recommendation 39.

<sup>42</sup> id, recommendation 40.

<sup>43</sup> id, recommendation 42.

<sup>44</sup> id, recommendation 43.

unless the financial market license specifically permits such activity.<sup>45</sup> These controls extend to cross-border marketing.

Second, the legislation will cover OTC insider trading and market manipulation offence provisions, modified to take into account of OTC practices.<sup>46</sup>

Third, the ASC will have comprehensive investigative and enforcement powers concerning any aspect of OTC markets or transactions, including the power to accept legally enforceable undertakings from derivatives market participants.<sup>47</sup>

## Summary and Assessment

### Broad Regulatory Approach

Generally, regulators can approach the task of regulating OTC derivatives by focussing on *what* business is done; *who* does the business; *with whom* business is done; or *how* business is done.<sup>48</sup> The proposed regulatory system for OTC markets is liberal on *what* business is done. There are no prohibitions on the types of OTC products that may be offered or for what purposes they should be used. However, certain regulated entities like money market dealers, superannuation funds and insurance companies are restricted in the types of derivatives activities that they may engage in by their respective regulators. The regulatory system concentrates on *who* does business by requiring that only OTC markets and intermediaries that meet agreed criteria be authorised.

While a general-principle based criteria will apply to OTC markets, a more prescriptive criteria will be adopted for intermediaries. The system also lays down rules on *how* business is to be conducted and prohibits certain types of market behaviour. For example, there are rules regulating the relationship between intermediaries and their clients. The application of these rules depends on *with whom* business is done. Market intermediaries will be subject to less onerous obligations when dealing with wholesale than with retail clients.

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<sup>45</sup> id, recommendation 45.

<sup>46</sup> id, recommendation 46.

<sup>47</sup> id, recommendation 48.

<sup>48</sup> See Little, T B, "An Overview of Regulation in the UK", in Bettelheim, E, Parry, H, and Rees, W, (eds), *Swaps and Off-Exchange Trading: Law and Regulation*, FT Law & Tax, London, 1996, p 41.

### Weaknesses of the Proposed Approach

There are a number of criticisms that may be levelled not only against the specific recommendations, but also against the overall regulatory approach suggested by CASAC.

First, the recommendation to require persons conducting OTC markets to seek authorisation would only create greater uncertainty in the market as the definition of derivatives market would cover activities not intended to by CASAC. This may lead to a rush in applications for authorisation from persons who may potentially be subject to licensing as intermediaries. A question that comes to mind is whether there is any need in the first place for OTC markets to be authorised. After all most participants such as banks are already subject to some form of regulation. Is there a need for an additional overlay of regulation? What is the purpose of authorising OTC markets when they are not going to be required to provide contract protection mechanisms or fidelity funds arrangements?

Second, the authorisation of markets coupled with the licensing of intermediaries (including market-makers) would certainly raise the costs of regulatory compliance. Market participants may be forced to externalise their costs or move their businesses offshore. With increasing globalisation and advances in technology, markets are increasingly integrated. The imposition of statutory regulation may place Australia at a competitive disadvantage, especially if it is perceived that regulation is unnecessary. The reality is that OTC derivatives markets have functioned well to date, largely without any regulation.<sup>49</sup> The absence of regulatory controls in OTC markets, far from impeding their development, have probably contributed to their phenomenal success. However, it is conceded that some change in the status quo may be inevitable given the current concerns about OTC derivatives.

Third, OTC derivatives activities do not take place in a legal vacuum. For example, OTC transactions are subject to all the normal principles of common law and equity. OTC participants may also be liable in contract, tort or under consumer protection legislation like the *Trade Practices Act 1974* (Cth) for misrepresentation or misleading and deceptive conduct. There are sufficient general law remedies to deal with the grievances

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<sup>49</sup> See Cullen, already cited n 1, p 29.

raised in cases like Gibson Greetings and Procter & Gamble. Why then is it necessary to introduce statutory obligations like the 'know your client' rule which may be impractical for derivatives? Moreover, issues like lack of capacity and the enforceability of netting arrangements may only be addressed through changes to the general law.

Fourth, although the impetus for regulating the OTC markets came largely from the need to address the various risks posed by derivatives, some of the regulatory proposals bear little relevance to the losses suffered by counterparties. It has been suggested by one commentator that those losses were the result of sophisticated institutions taking on risks beyond their investment needs or risk capacity.<sup>50</sup> For example, it has been suggested that the collapse of the Barings group was due to the incompetence of its managers and their failure to supervise the activities of their Singapore-based trader, Nicholas W Leeson.<sup>51</sup> Gibsons Greetings and Procter and Gamble incurred large losses on their swaps because they were unable to adequately assess their risks.<sup>52</sup> These shortcomings are unlikely to be corrected by capital or similar requirements. When company officers fail to discharge their management responsibilities properly, should they not be subject to the laws relating to corporate governance?

Finally, the paradigm that regulation is a panacea for all ills may be misguided, as least in so far as the OTC derivatives markets are concerned. There are a host of non-regulatory solutions that should be explored before the introduction of regulatory controls. Collateralisation of transactions, the use of well-drafted legal documentation, greater disclosure of OTC derivatives activities, and the introduction of clearing houses for certain OTC derivatives are just some of the possible solutions.

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<sup>50</sup> See Markham, J W , "Derivatives Instruments: Obstacles to their Regulation in the US", in Bettelheim, E, Parry, H, and Rees, W, (eds), *Swaps and Off-Exchange Trading: Law and Regulation*, FT Law & Tax, London, 1996, p 287.

<sup>51</sup> See Samuelson, C A, "Fall of Barings: Lessons for Legal Oversight of Derivatives Transactions in the United States" (1996) 29 *Cornell International Law Journal* 767.

<sup>52</sup> See Crawford, G, and Sen, B, *Derivatives for Decision Makers*, John Wiley & Sons, New York, 1996, p 143.

## Conclusion

Undeniably, most of the recommendations made by CASAC would improve the level of protection afforded to OTC market participants. Some of the recommendations, such as the provision of risks disclosure statements, have already been adopted by intermediaries on their own initiative. This article is not so much concerned with whether there should be regulation, but what form it should take. It is submitted that based on the structure of OTC markets and the nature of the transactions, a non-statutory regulation may be a better approach. The Australian regulators should encourage OTC market participants to adopt a voluntary code of practice. Only if this approach fails, should they consider the introduction of statutory rules. This code of practice may include most of the regulatory controls suggested by CASAC.

A voluntary code is not only more flexible than statutory rules, but will also benefit from greater practitioner-input. The code may be administered by an industry-based body like the Australian Financial Markets Association. Alternatively, OTC participants may be encouraged to form a new self-regulatory body. Statutory rules are by nature prescriptive and they tend to encourage creative compliance. In other words, they have a tendency to encourage literal compliance, but not compliance with the spirit of the law. It must also be remembered that at current rates of development, the nature of OTC derivatives products may radically change in the next few years. Detailed rules are hardly suitable for the regulation of such products. Lastly, statutory rules encourage excessive legalism, which would only raise the costs of regulatory compliance. It is therefore important, in the interests of OTC derivatives participants, that Australian regulators rethink their regulatory strategy.