Financial Markets and Investment Products

Promoting competition, financial innovation and investment

Corporate Law Economic Reform Program
Proposals for Reform: Paper No. 6

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TABLE OF CONTENTS

Page

Abbreviations vi

PART 1: Reform Proposals 1

PART 2: Introduction 7

2.1 Background 7
2.2 Scope of this Paper 8
2.3 Government Response to Financial System Inquiry Recommendations 9
2.4 Basis of New Regulatory Regime for Financial Markets and Investment Products 10

PART 3: The Role of Financial Markets and Regulation 13

3.1 Australian Financial Markets 13
3.2 The Role of Financial Markets 20
3.3 Reassessing Market Regulation 22
3.4 Objectives of Market Regulation 26
3.5 Overseas Experience 30

PART 4: Financial Instruments 33

4.1 Introduction 33
4.2 Current Regulation of Securities and Derivatives Markets 33
4.3 Problems with Current Regulation of Securities and Derivatives Markets 34
4.4 Current Regulation of other Financial Products 39
4.5 Functional Regulation 40
4.6 Harmonisation of Financial Markets Regulation 41
4.7 Regulatory Approach 41
4.8 Definition of Financial Instruments 44
4.9 Advantages of Harmonised Regulation 44

PART 5: Harmonising Regulation — Efficiency and Consistency 47

5.1 Introduction 47
5.2 Current Regulation 47
5.3 Problems with Current Regulation 56
5.4 Proposal for Reform 59
5.5 Application of Proposed Reforms 66

PART 6: Market Facilities 69

6.1 Introduction 69
6.2 When will a Market Operator's Licence be Required? 69
6.3 Criteria for Market Operator's Licence 70
6.4 Market Fragmentation 73
6.5 Competition Issues 74

PART 7: Clearing and Settlement Facilities 77

7.1 Introduction 77
7.2 Nature of Clearing and Settlement Facilities 77
7.3 Types of Clearing and Settlement Facilities 78
7.4 Systemic Risk 80
7.5 Financial System Inquiry Recommendations 82
7.6 Clearing and Settlement Licence 83
7.7 When will a Clearing and Settlement Licence be Required? 83
7.8 Criteria for Clearing and Settlement Licence 84

PART 8: Financial Intermediary's Licence 89

8.1 Introduction 89
8.2 Licensing Financial Intermediaries 89
8.3 Who will need a Financial Intermediary's Licence? 91
8.4 Wholesale Financial Intermediaries 92
8.5 Licence Criteria 93

PART 9: Conduct of Business by Financial Intermediaries 99

9.1 Introduction 99
9.2 Conduct of Business Requirements 99
9.3 Scope of Business Conduct Requirements 104

PART 10: Disclosure 105
10.1 Introduction 105
10.2 FSI and CLERP Fundraising Proposals 105
10.3 Proposals for Reform 107

PART 11: Conduct in Relation to Financial Instruments 113
11.1 Introduction 113
11.2 Current Regulation 113
11.3 Proposals for Reform 114

PART 12: Regulatory Responsibility 117
12.1 New Regulatory Framework 117
12.2 Australian Corporations and Financial Services Commission 117
12.3 Regulation of Financial Markets and Investment Products 118
12.4 Delegating to Industry Bodies 120
12.5 Information Sharing between Regulators and Industry Bodies 121

Appendix A: Business Regulation Advisory Group 125
Appendix B: Overseas Approach 127
Appendix C: Description of Financial Instruments 133
Appendix D: Description of Retail Investor 137

ABBREVIATIONS

ACCC	Australian Competition and Consumer Commission
ACFSC	Australian Corporations and Financial Services Commission
AFIC	Australian Financial Institutions Commission
AFMA	Australian Financial Markets Association
AOM	Australian Options Market
APRA	Australian Prudential Regulation Authority
APCA	Australian Payments Clearing Association
ASC	Australian Securities Commission
ASX	Australian Stock Exchange
CASAC	Companies and Securities Advisory Committee
CHESS	Clearing House Electronic Subregister System
CLERP	Corporate Law Economic Reform Program
CFTC	Commodity and Futures Trading Commission (US)
FRA	Forward Rate Agreement
FSA	Financial Services Authority (UK)
FSI	Financial System Inquiry
GDP	Gross Domestic Product
IOSCO	International Organisation of Securities Commissions
ISC	Insurance and Superannuation Commission
LEPOs	Low Exercise Price Options
OCH	Options Clearing House
OTC	Over the Counter
PSB	Payments System Board
RBA	Reserve Bank of Australia
RITS	Reserve Bank Information and Transfer System
RTGS	Real-time Gross Settlement
RSAs	Retirement Savings Account
SCH	Securities Clearing House
SEATS	Stock Exchange Automated Trading System
SEC	Securities and Exchange Commission (US)
SFE	Sydney Futures Exchange
SIB	Securities Investment Board (UK)
SFECH	Sydney Futures Exchange Clearing House
SRO	Self Regulatory Organisation
SYCOM	Sydney Computerised Overnight Market

PART 1: REFORM PROPOSALS

PROPOSAL NO. 1 — UNIFORM REGULATION OF FINANCIAL INSTRUMENTS

A more efficient and flexible regime for financial markets and investment products will be achieved by developing an integrated regulatory framework for financial instruments. The new regulatory regime will provide consistent regulation of functionally similar markets and products.

Financial instruments will include all securities, futures and other derivatives as well as foreign exchange, superannuation, general and life insurance and deposit accounts (see Appendix C).

The existing diverse regulatory arrangements for financial markets and investment products under the Corporations Law, the Insurance (Agents and Brokers) Act, the Insurance Contracts Act, the Banking Act, the Superannuation Industry (Supervision) Act and various industry codes will be harmonised.

PROPOSAL NO. 2 — NEW REGULATORY FRAMEWORK

Persons will be prohibited from conducting a market in financial instruments or providing financial intermediary services unless they hold an appropriately endorsed financial markets licence. The financial markets licence will have three categories:

- a licence to operate a market facility;
- a licence to operate a clearing and settlement facility; and
- a licence to provide financial intermediary services.

The criteria to be satisfied in order to obtain a licence will be broadly stated and flexible to accommodate different market structures, investment products and financial intermediary services. The way in which these legislative

requirements will be satisfied will vary according to the nature of the services provided.

Proposal No. 3 — Market Facilities

A licence to operate a market will be required if a person proposes to provide a market facility:

- where financial instruments are regularly traded or information is provided about the prices at which persons may expect to trade financial instruments; and
- which involves multiple buyers and sellers.

The criteria to be satisfied to obtain a licence to conduct a market facility will be that the market operator must:

- have adequate arrangements for the supervision of the market;
- have and maintain sufficient resources to conduct the market and carry out supervisory functions;
- have adequate rules or procedures for the operation of the market, including access to market facilities, the recording and disclosure of transactions effected on the market and procedures for dealing with complaints;
- have adequate arrangements for the clearing and settlement of transactions; and
- have adequate protection for retail investors.

The legislation will set out the ongoing obligations which will be imposed on a market operator to ensure that the objectives of market regulation are satisfied on a continuing basis.

Proposal No. 4 — Clearing and Settlement Facilities

A licence to operate a clearing and settlement facility will be required where the clearing and settlement services are not conducted by a licensed market operator.

The criteria to be satisfied to obtain a licence to operate a clearing and settlement facility will be that the facility provider must:

- have adequate rules or procedures for the operation of the facility;
- have adequate arrangements for the supervision of the facility; and
- have and maintain sufficient resources to conduct the facility and perform supervisory functions.

The legislation will impose ongoing obligations on clearing and settlement facility providers to ensure that the objectives of market regulation are satisfied on a continuing basis.

PROPOSAL NO. 5 — FINANCIAL INTERMEDIARIES

A single licensing regime will be introduced for financial market dealers and advisers.

The criteria to be satisfied to obtain a financial intermediary's licence will be that the intermediary must:

- have adequate financial resources for the performance of the proposed activities; and
- have the competence, skills and experience to provide the relevant services.

Conditions will be imposed on a financial intermediary's licence to ensure that the objectives of market regulation are satisfied on a continuing basis.

PROPOSAL NO. 6 — CONDUCT OF FINANCIAL INTERMEDIARY'S BUSINESS

Statutory obligations will be imposed on intermediaries in relation to their dealings with retail investors including requirements relating to:

- risk disclosure;
- confirmation documentation and periodic statements;
- accounts and record keeping;
- benefits disclosure;

- pressure sales;
- the suitability of personal product recommendations; and
- complaints and dispute resolution.

PROPOSAL NO. 7 — DISCLOSURE

It is highly desirable that a consistent and comparable disclosure regime for all financial instruments be developed. The Government seeks comments on the proposed formulation of the disclosure standard including how a regime may be developed to assist investors to make comparisons across all financial instruments.

All financial instruments, other than securities which are subject to the prospectus provisions, will be subject to a requirement to disclose all relevant information to permit investors to make informed investment decisions. The disclosure document must address specific issues in order to increase comparability across similar investment products. Promoters or issuers of financial products will be required to disclose to investors the fundamental terms and obligations attaching to a financial product as well as the risks involved with the product and all fees, commissions and charges.

The fundraising provisions will apply to specified financial instruments (shares, debentures, managed investments). The development of profile statements under the Corporations Law will assist investors to compare securities and other financial instruments.

PROPOSAL NO. 8 — MARKET MISCONDUCT

The market misconduct provisions of the Corporations Law, which include insider trading and market manipulation will be harmonised for all markets where financial instruments are regularly traded by multiple buyers and sellers.

Rules relating to misconduct by financial advisers and dealers, including breaches of licence conditions, will be harmonised and enforced by the ACFSC.

PROPOSAL NO. 9 — REGULATORY RESPONSIBILITY

The proposed implementation of the reforms to the regulation of financial markets and investment products will result in a new approach to the regulation of financial market participants. The Government seeks comments on the appropriate mechanisms for responsibility for the new regulatory regime.

One option would be to retain the current division of responsibility for regulating markets and intermediaries as adopted by the Corporations Law. The Treasurer would be responsible for licensing markets, clearing and settlement facilities and considering amendments to market rules. The Australian Corporations and Financial Services Commission (ACFSC) would administer the licensing regime for financial advisers and dealers. If the Treasurer is of the opinion that a market is not complying with its ongoing obligations, the Treasurer may publish a notice in the Gazette directing the market to do specified things that the Treasurer believes will promote compliance by the market with those requirements.

An alternative approach would be to provide the ACFSC with responsibility for the day to day administration of the new regulatory regime. The ACFSC would be responsible for all aspects of the single licensing regime, including licensing markets, clearing and settlement facilities and financial advisers and dealers. The ACFSC would oversee the product disclosure requirements for all financial instruments and have broad enforcement powers relating to financial markets and investment products.

Given the economic significance of markets and investment products, the Treasurer would oversee the performance of the ACFSC through the following mechanisms:

- the Treasurer may give directions to the ACFSC about the priorities and policies it must pursue in carrying out its functions;
- the ACFSC must report annually to the Treasurer on the exercise of its discretions, including the number of applications for licences and the numbers granted and refused;
- the ACFSC must immediately notify the Treasurer of any matters which would have significant ramifications for the regulation of the financial system; and

- the Treasurer may ask the ACFSC to provide a special report on the performance of its functions and the exercise of its powers in relation to financial markets.

If the Treasurer is of the opinion that a market is not complying with its ongoing obligations, the Treasurer may publish a notice in the Gazette directing the market to do specified things that the Treasurer believes will promote compliance by the market with those requirements.

Accountability of the ACFSC would also be provided through:

- subjecting decisions to a right of review;
- clarifying the charter of the regulator — eg, the ACFSC must facilitate competition and financial innovation, and the development of new markets while maintaining market integrity and investor confidence; and
- utilising the Financial Sector Advisory Council to gain feedback from the business community on the operation of the new regime.

PART 2: INTRODUCTION

2.1 BACKGROUND

Australian financial markets perform a fundamental economic function by facilitating the allocation of savings and resources to their most productive uses. Securities, derivatives and other investment markets can materially influence the long term financial security of many Australians. Household investment in financial assets is steadily increasing and financial markets play a key role in the pricing and management of these assets.

Efficient and credible financial markets will more readily attract domestic and foreign investment which, in turn, will contribute to the Government's broader policy objectives of increased employment and sustainable economic growth. For example, efficient stock markets facilitate the flow of capital into private enterprise which promotes employment and business expansion.

To make Australia a leading edge financial centre we must develop a regulatory regime that encourages innovation and competition through providing a flexible and adaptable framework. The reforms proposed in this paper form a significant plank in the Government's commitment to building Australia as a major financial centre. This will encourage investment and jobs.

Financial markets and intermediaries have experienced major change since the development of the current regulatory framework. Technological developments, globalisation and increased competition have had a major impact on market services and products. These forces are blurring traditional boundaries between institutions and products and presenting greater choices for investors. Also, retail investment is growing as a result of the heightened awareness of the need to provide for retirement and the attractiveness of large privatisations as investment vehicles. This highlights the need to ensure that regulation provides appropriate protection for retail investors which will encourage participation by first time investors.

The current regulatory framework has been criticised for failing to keep pace with market developments and modern commercial practices. Given the important role of financial markets in the Australian economy, it is critical that the regulatory regime for markets and financial intermediaries is consistent with the Government's wider economic objectives. Market regulation needs to

be reassessed to ensure that it takes account of the realities of the modern commercial environment and permits market participants to respond to the challenges presented by financial innovation and globalisation in a timely and sensitive manner. The regulatory regime should facilitate the mobilisation and investment of savings by the development of new and diverse markets and financial products, while at the same time enhancing efficiency, integrity and investor confidence.

To this end, this paper forms part of the Government's Corporate Law Economic Reform Program (CLERP) which is reviewing key areas of business regulation to ensure that it is consistent with promoting a strong and vibrant economy. The policies outlined in the paper have been developed in consultation with a broad range of individuals and associations in the business and professional communities, as well as the Business Regulation Advisory Group (see Appendix A).

2.2 SCOPE OF THIS PAPER

The purpose of this paper is to identify the objectives of financial market regulation and propose a flexible, forward looking regulatory regime to satisfy those objectives. The proposals outlined in this paper deal with the Financial System Inquiry, Final Report (FSI) recommendations to:

- provide consistent and comparable disclosure obligations for retail financial products including the introduction of profile statements (Recommendations 8 and 9);
- introduce a single licensing regime for financial sales, advice and dealings with separate categories for investment advice on financial products (Recommendations 13 and 15);
- replace the current regulation of securities and futures with a broader regulatory framework for 'financial products' (Recommendation 19);
- permit retail participation in over the counter (OTC) derivatives markets (Recommendation 20);
- introduce a single authorisation procedure for financial exchanges (Recommendation 21);
- provide comparable regulation of financial exchanges and OTC markets (Recommendation 22);
- regulate OTC markets through the licensing regime (Recommendation 23);
- authorise clearing and settlement facilities (Recommendation 24); and

- harmonise the regulation of collective investments and public offer superannuation (Recommendation 89).

Other recommendations of the FSI which will affect the financial markets include recommendations relating to the role and powers of the regulator. The proposals for reform are consistent with the FSI recommendations to:

- establish a single agency called the Australian Corporations and Financial Services Commission (ACFSC) with comprehensive responsibilities to oversee the Corporations Law, financial market integrity and financial sector consumer protection (Recommendations 1 and 2); and powers to use a combination of regulatory approaches including the adoption of codes (Recommendation 7);
- retain the Australian Competition and Consumer Commission (ACCC) responsibility for competition issues (Recommendations 5 and 80);
- permit the ACFSC to devolve responsibility for accrediting market participants to industry bodies (Recommendation 14);
- provide the ACFSC with broad enforcement powers (Recommendation 27);
- improve reporting requirements of regulatory agencies (Recommendation 109);
- place responsibility for the regulation of exchange risk controls with the ACFSC (Recommendation 57);
- ensure that all regulatory agencies monitor the evolution of wholesale markets for the presence of institutions that are not otherwise subject to local or overseas regulation or prudential oversight (Recommendation 58); and
- encourage the ACFSC to participate in global regulatory programs in relation to cross-border financial transactions(Recommendation 29).

This paper also deals with the recommendations of the Companies and Securities Advisory Committee Final Report on the Regulation of On-Exchange and OTC Derivatives Markets (CASAC).

2.3 GOVERNMENT RESPONSE TO FINANCIAL SYSTEM INQUIRY RECOMMENDATIONS

On 2 September 1997, the Treasurer announced the Government's response to the FSI recommendations. The Government has agreed to establish a new

regulatory framework for the financial system. The agreement of the States and Territories will be required in order to establish the proposed regulatory framework.

Three regulatory agencies, each with system-wide responsibilities for the different objectives of government intervention in the financial system, will form the new framework:

- the Reserve Bank of Australia (RBA) will be responsible for monetary policy, financial system stability and regulation of the payments system;
- an Australian Prudential Regulation Authority (APRA) will provide prudential regulation for deposit taking institutions, life and general insurance companies, and superannuation funds; and
- an Australian Corporations and Financial Services Commission (ACFSC) will provide regulation for the integrity of market conduct, consumer protection and corporations.

There will be legislative provisions to authorise the exchange of confidential information among the three regulators and there will be close co-operation between them, both bilaterally and through a Council of Financial Regulators for coordination across a wide range of issues.

2.4 Basis of New Regulatory Regime for Financial Markets and Investment Products

The new regulatory regime for financial markets and investment products is based upon:

- providing comparable regulation of all financial products, including securities, derivatives, superannuation, life and general insurance and bank-deposit products;
- licensing financial markets and providing consistent and comparable regulation for similar financial products;
- licensing all financial intermediaries and imposing harmonised statutory obligations designed to protect retail investors; and
- ensuring that ‘promoters’ or issuers of financial products provide comprehensible disclosure documents which assist investors to make informed decisions.

Significant benefits will be conferred on market participants and investors by providing a more uniform regulatory regime for financial markets, intermediaries and investment products. The development of a single regulatory regime will reduce administration costs and the costs imposed on intermediaries who must currently comply with different regulatory regimes. The proposals will also provide more certainty by removing unnecessary distinctions between financial products and encourage competition by providing a more competitively neutral regime for the regulation of markets and intermediaries.

PART 3: THE ROLE OF FINANCIAL MARKETS AND REGULATION

3.1 AUSTRALIAN FINANCIAL MARKETS

Financial markets are continually evolving in response to developments in technology, financial innovation and globalisation. This Part discusses the main securities and derivatives markets operating in Australia today, as well as other key investment markets.

The Australian financial markets include equity, bond, derivatives and debt markets. Superannuation, insurance and managed funds are also important investment industries. Service providers in the financial markets include organisations which provide market facilities for the trading of financial instruments, clearing and settlement facilities and intermediaries who provide a range of broking and advising services. Foreign investors, institutions and fund managers are key users of the financial markets while private retail investors remain an important investment group within Australia.

A summary of total market turnover for exchange-traded and OTC markets is contained in Table 1. The importance of financial markets to the Australian economy is demonstrated by the steady increase of investment in financial assets. In 1997 the total market turnover for these financial markets was approximately $33 trillion (Table 1). Investment in superannuation products is currently valued at $304 billion and is rapidly becoming the most valuable asset for many Australians.

Table 1: The Australian OTC & Exchange Traded Financial Markets: Summary of Total Market Turnover ($A billion)

Market	1994	1995	1996	1997	Latest per cent Change
Exchange Traded Markets					
Equities	128	118	159	212	34
Futures	6 209	7 151	6 623	8 711	32
OTC Financial Markets					
Foreign Exchange	14 893	15 093	15 207	17 728	17
Currency Options	175	199	222	349	57
Long Dated Securities	1 092	1 557	1 172	1 416	21
Repurchase Agreements	870	1 505	1 484	2 413	63
Short Dated Instruments	1 024	980	1 113	1 334	20
Forward Rate Agreements	676	1 025	664	485	(27)
Swaps	273	317	349	410	17
Interest Rate Options	69	60	58	70	21
Total	19 072	20 736	20 269	24 205	19
All Markets	**25 409**	**28 005**	**27 051**	**33 128**	**22**

Source: AFMA 1997 Australian Financial Market Report, page 3.

Securities Markets

The Australian Stock Exchange (ASX) is Australia's national exchange for the trading of securities of over 1200 Australian and foreign companies. The ASX was the tenth largest national equities market in the world in the 1996-97 financial year, quoting shares of domestic companies worth $444 billion and of foreign companies worth $290 billion.[1] The value of equity turnover for the 1996-97 financial year was $212 billion, over 33 per cent higher than in 1995-96.[2]

The ASX also conducts markets in derivative products including warrants, Low Exercise Price Options (LEPOs) and share ratio contracts. The ASX, through the Australian Options Market (AOM), operates the ninth largest equity options market in the world. In the 1996-97 financial year the trading

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1 *ASX Annual Report*, 1997 p 14.
2 *ASX Market Report*, 1997 p 1.

volume in warrants, a product primarily aimed at retail investors, increased by 379 per cent to $2.6 billion, while the value of trading increased 255 per cent to $1.34 billion.[3]

ASX members recently voted to change the ownership structure of the exchange from a traditional, membership-based exchange to a public company which will operate for profit. The ASX considers that the change will permit the exchange to respond more readily to financial evolution and competition. The Corporations Law Amendment (ASX) Bill, which was passed by Parliament in November 1997, will facilitate the proposed ASX demutualisation.

Futures Market

The Sydney Futures Exchange (SFE) began in 1960 as the Sydney Greasy Wool Futures Exchange which only listed wool futures for the first 15 years. Trading participation and general public awareness increased in the late 1970's, with the introduction of gold, currency and interest rate futures contracts.

Today the SFE conducts trading in a range of financial and commodity futures including contracts in bank bills, Treasury bonds, the share price index and various commodities including wool, wheat and electricity. Overall, the SFE total turnover for the 1996-97 financial year increased by 31.5 per cent to $8.7 trillion.[4]

The SFE currently utilises an open outcry method of floor trading. The SFE runs the Sydney Computerised Overnight Market (SYCOM), a computerised trading system which accounted for 10 per cent of the total trading for 1997. SYCOM trading in the 1996-97 financial year increased by 30 per cent to a record 3.3 million contracts.[5] The SFE also owns the New Zealand Futures and Options Exchange and has a direct trading link with the New York Mercantile Exchange and the Chicago Mercantile Exchange. The SFE recently announced its intention to move towards a fully automated trading system by 1999.

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3 *ASX Market Report*, 1997 p 8.

4 *Australian Financial Markets Association (AFMA) Financial Markets Report*, 1997 p 23.

5 *AFMA Financial Markets Report*, 1997 p 23.

Bond Market

The bulk of bond trading in Australia takes place on the over the counter (OTC) market. Only a small number of bonds are traded on the ASX.

Bonds remain a very important component of Australian financial markets and are the primary market in which prevailing interest rates are determined.

Total reported market turnover for short dated instruments during the 1996-97 financial year exceeded $1.3 trillion, an increase of 20 per cent from the last financial year. The majority of trading was represented by bank paper ($1 trillion). Corporate trading was up by 39 per cent from the last financial year to $208 million.

Turnover in long dated instruments during the 1996-97 financial year was $1.4 trillion, representing a 21 per cent increase from the previous financial year. The major turnover in long-dated instruments was in Commonwealth and State Government bonds.[6]

There is also a well-developed semi-government bond market, such as for corporatised utilities and other government owned business enterprises.[7]

Corporate Debt

The Australian equity market is more extensive and active than the market for corporate debt securities. There has never been a competitive corporate debt market in Australia. Corporations raising debt capital through large public issues often look to the more liquid off-shore markets.[8]

Over the Counter Derivative Markets

Transactions negotiated between institutions and professional dealers make up the 'OTC markets'. There is no central marketplace or facility which matches buyers and sellers. Participants deal bilaterally through telephone and computer systems. The major OTC derivatives markets are in currency options, forward rate agreements (FRA), interest rate swaps and interest rate options.

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6 *AFMA Financial Markets Report*, 1997 pp 40, 45.
7 The Allen Consulting Group Pty Ltd, *Australia's Capital Markets,* p 110.
8 The Allen Consulting Group Pty Ltd, *Australia's Capital Markets,* p 1.

OTC markets exceed exchange-traded markets in terms of value of outstanding instruments and daily turnover.[9] Turnover in OTC markets in 1996-97 generally increased: for example the currency option market increased by 99 per cent to $349 billion[10] and the interest rate options market experienced an increase of 21 per cent to $70 billion.[11]

Foreign Exchange

Foreign exchange represents the cash and other claims (such as bonds) held in the currency of another country. While the foreign exchange markets originally developed to serve international trade and the international movement of money and capital, the turnover of foreign currency in a given period now vastly exceeds world trade. While foreign exchange market activity is dominated by speculation, arbitrage and professional dealing, this activity enhances efficiency by adding depth to the market.

The total turnover in foreign exchange during the 1996-97 financial year was $17.7 trillion, which represented more than 50 per cent of total turnover in Australia's financial markets of $33 trillion.[12] Transactions are bilaterally negotiated between institutions and there is no centralised wholesale market in foreign currency.

Superannuation

Compulsory superannuation has resulted in a large increase of investment in superannuation products relative to other investment products. These assets are channeled into the funds management industry which means that an increasing proportion of household sector investment is in market linked investment. The increasing exposure of household investment to market risk underscores the importance of effective regulation of Australian financial markets. The value of total assets in the superannuation system as of 30 June 1997 was $304 billion, representing a growth rate of 20 per cent for the financial year. Contributions for the financial year increased from $26.3 billion to $29.5 billion (12 percent). The strongest growth came from member contributions, increasing by 17 per cent over the previous year to $10 billion, and employer contributions increased by 10 per cent to $19.5 billion. The

9 Bank for International Settlements, *Central Bank Survey of Foreign Exchange and Derivatives Market Activity*, 1995.
10 *AFMA Financial Markets Report*, 1997 p 36.
11 *AFMA Financial Markets Report*, 1997 p 3.
12 *AFMA Financial Markets Report*, 1997 p 3.

number of superannuation accounts is now 16.8 million, which represents approximately 6.7 million members.[13]

Insurance

As at December 1996, there were 52 life insurance companies operating in Australia, managing $134 billion in assets and representing 10.7 million individual and group policies. During 1996, life insurance companies received $24 billion in premiums and paid $19 billion in benefits.[14] Superannuation business now makes up 76 per cent of all life office assets and accounts for 86 per cent of premiums, with risk based life insurance representing only 14 per cent of premiums.[15] Investors may now purchase insurance products from a broad range of institutions including life companies, life agents and brokers, banks and superannuation funds.[16]

There were also 169 private sector and 17 public sector general insurers operating in Australia's $57 billion general insurance market. As at 30 June 1996, private sector general insurers held $36 billion in assets.

Managed Funds Industry

The managed funds industry comprises many forms of investment institutions, including life insurance offices, superannuation funds, public unit trusts, friendly societies and cash management trusts. These institutions invest in a wide range of assets, including cash and deposits, loans, short and long term securities, equities and property.

The value of the total consolidated assets of managed funds in Australia as at 30 June 1997 was $381.6 billion, an increase of $27.3 billion (8 per cent) over only three months.[17] Chart 1 shows the growth in the value of total consolidated assets of managed funds in Australia since June 1995.

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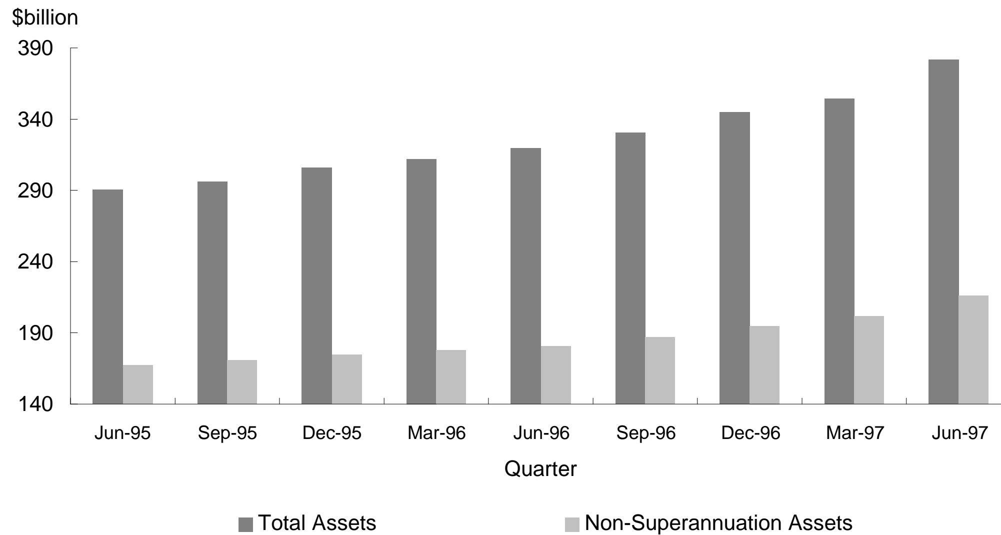
13 Insurance and Superannuation Commission, Media Release, October 1997.
14 *Insurance and Superannuation Commission Bulletin.*
15 *Insurance and Superannuation Commission Bulletin.*
16 *Financial System Inquiry Final Report*, p 632.
17 Australian Bureau of Statistics, *Managed Funds*, June Quarter 1997.

Alongside the considerable growth in superannuation, other parts of the managed funds industry have also grown over recent times (also see Chart 1).



Source: *Managed Funds*, Australian Bureau of Statistics, June Quarter 1997.

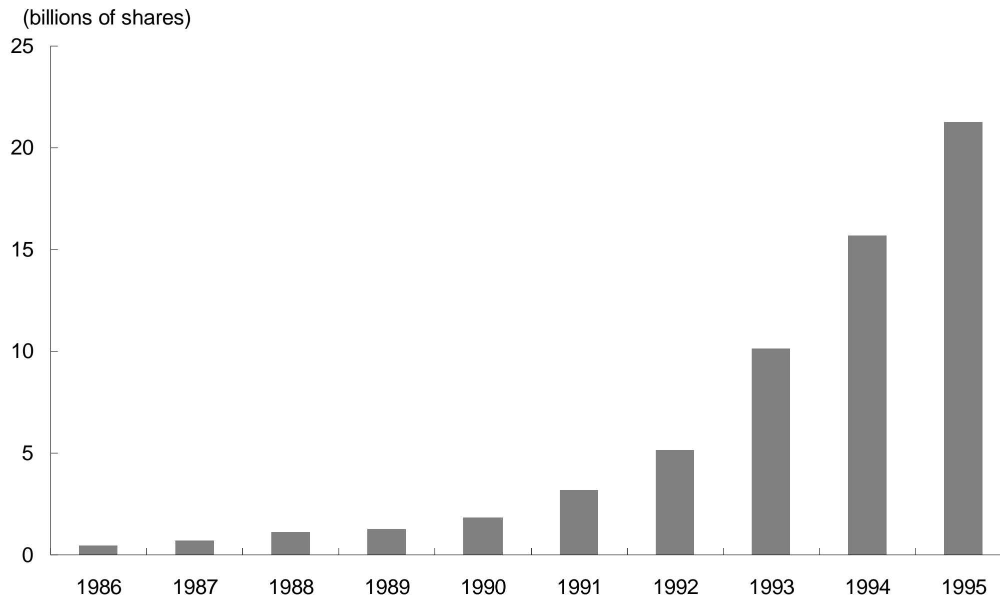
Alternative Markets

Worldwide, market participants are harnessing technological developments to produce innovative systems which provide cost-effective trading opportunities for professional investors. For example, Instinet, which was acquired by Reuters in 1987, provides a computer based platform which permits the real time global trading of securities listed on 16 exchanges.[18] Low commissions and reduced costs associated with market impact means that systems like Instinet may undercut traditional brokerage services.

18 Internet, ***http:/www.instinet.com/***

Instinet volume has steadily increased. In 1995, 21.29 billion shares were traded (Chart 2). Instinet, however, does not currently operate in Australia.

Chart 2: Instinet Volume Over Time



Source: Foster & Kleidon, *Strategic Analysis at the Australian Stock Exchange*, ASX, March 1997.

Volume has also increased on another alternative trading system, Posit,[19] which permits confidential matching of securities transactions at the midpoint of the bid-offer spread. Posit provides pools of liquidity at certain times throughout the trading day. The anonymous matching system significantly reduces market impact which is the single largest factor in transaction costs. Australian Posit, commenced in 1995 and matched 145 million shares with a value of $56 million in its first year.

3.2 THE ROLE OF FINANCIAL MARKETS

Financial markets perform a number of essential functions including:

- mobilising and directing savings to their most productive uses;

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19 Internet, ***http:/www.itginc.com/products/posit.html***

- providing price discovery through the exchange and evaluation of information;
- facilitating the management and pricing of risk;
- assisting individuals in assessing and making investment decisions by reflecting risk in the pricing of financial instruments; and
- facilitating capital raising by a diverse range of firms.

Price discovery is a function of financial markets to varying degrees. Price discovery is traditionally associated with financial exchanges where liquid markets are highly transparent. However, price discovery is not necessarily restricted to traditional exchange environments and now often takes place across various markets. For example, derivative transactions on the SFE contribute to price discovery in related primary markets (eg ASX and bond market). Further, technology can now provide similar levels of price discovery in OTC markets through information transparency and liquidity.

Intermediaries provide important services in financial markets, which include providing advice on investment products, dealing or broking services and structuring and selling financial products. Intermediaries include financial planners, life, superannuation and insurance participants and deposit taking institutions.

Thriving financial markets benefit all sectors of the economy and have the potential to benefit all Australians. Over the period 1989 to 1996, financial assets in the household sector increased at an average rate of 7.7 per cent per annum, totaling approximately $640 billion in 1995-96.[20] Currently nearly 34 per cent of all Australian adults directly or indirectly own shares.[21] Financial markets facilitate the efficient management of these investments, including the management of risk.

Investors will more readily participate in markets which are perceived to be efficient and fair. Promoting market efficiency and investor confidence are key strategies in the development of active and liquid financial markets which in turn, facilitate investment, employment and wealth creation.

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20 *Financial System Inquiry Final Report*, March 1997, p 85 drawing on the *Reserve Bank of Australia Bulletin*, various editions 1989-96.

21 *ASX Australian Shareownership Survey*, 1997.

3.3 REASSESSING MARKET REGULATION

Current regulation of financial markets falls into two broad categories:

- regulation of securities and futures markets and intermediaries under the Corporations Law[22]; and
- regulation of other financial products, including superannuation, life and general insurance, foreign exchange and banking products by various pieces of industry specific legislation.[23]

Major changes in world financial markets since the development of the current regulatory framework necessitate a review of market regulation to ensure that it remains relevant and appropriate. It is important to take account of current market practices as well as considering the likely impact of future market developments. In light of the dynamic nature of financial markets, it is imperative that the regulatory regime is sufficiently flexible to permit Australian markets and investors to fully participate in the benefits of financial innovation and competition.

The FSI Report highlighted the forces for change operating on the financial system. These forces have had a profound and marked effect on the operation of securities, derivatives and other financial markets including:

- technology — the advent of cost efficient computer and telecommunications technology has radically changed the way markets and intermediaries operate. Technology has facilitated the development of new market structures and products which are not confined to traditional institutional or geographical boundaries;
- globalisation — Australian financial markets are becoming increasingly integrated with other world markets;

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22 The current regulation of securities and futures markets, contained in Chapters 7 and 8 of the Corporations Law, is substantially based on the co-operative scheme *Securities Industry Act 1980* and the *Futures Industry Act 1986*. Chapter 7 of the Law also includes the fundraising provisions previously located in the *Companies Act 1981*. Securities are regulated by Chapter 7 while the futures industry provisions are contained in Chapter 8 of the Law.

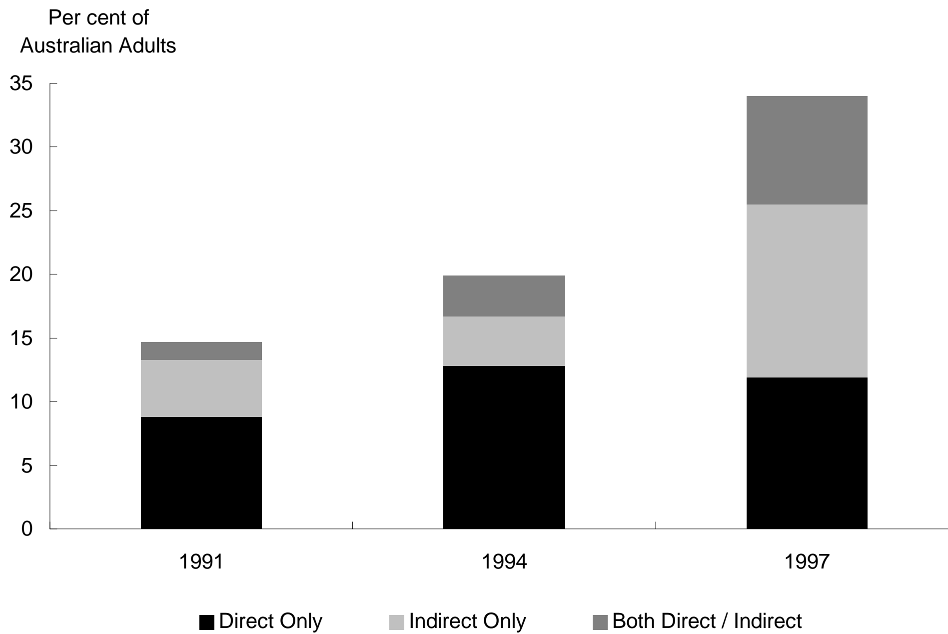
23 Including the *Insurance Contracts Act 1984*, the *Superannuation Industry (Supervision) Act 1993*, the *Insurance Act 1973*, the *Insurance (Agents and Brokers) Act 1984*, the *Banking Act 1959* and the *Life Insurance Act 1995*.

- innovation — one of the most striking features of financial innovation during the last decade has been the growth in the use and diversity of financial instruments including derivative products; and
- competition — traditional market structures like financial exchanges are facing unprecedented competition from international exchanges and innovative market facilities.

The regulatory framework for Australia's financial markets was developed under very different market conditions than those which exist today. Changes in market conditions include:

- a dramatic increase in financial market volumes — total market turnover has grown from $21 trillion in 1993 to $33 trillion in 1997[24];
- an increase in Australian share ownership — a recent survey indicates that approximately 1 in 3 Australians directly or indirectly own shares (Chart 3);

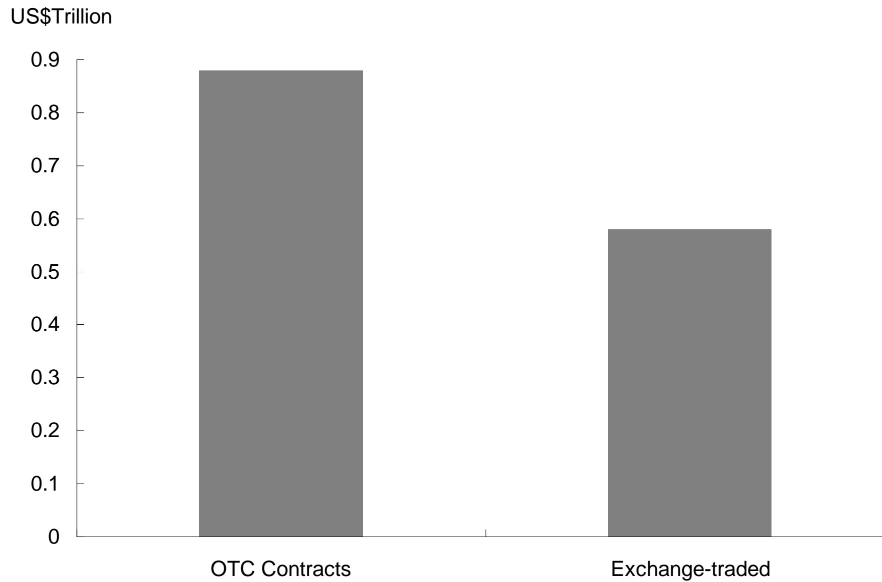
Chart 3: 1991-1997 Australian Share Ownership



Source: ASX Australian Share Ownership Survey, 1997.

24 *AFMA Financial Markets Report*, 1997, p 3.

- a rapid growth in OTC transactions which now exceed the turnover of exchange traded instruments — total market turnover for OTC markets in 1997 was $24.1 trillion compared with $8.9 trillion for exchanges.[25] Average daily turnover is illustrated by Chart 4;

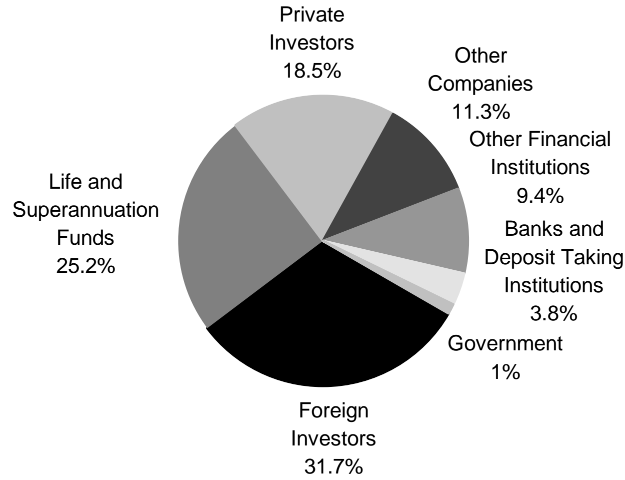


Source: BIS 1996, Central Bank Survey of Foreign Exchange and Derivatives market Activity 1995.

25 *AFMA Financial Markets Report*, 1997, p 3.

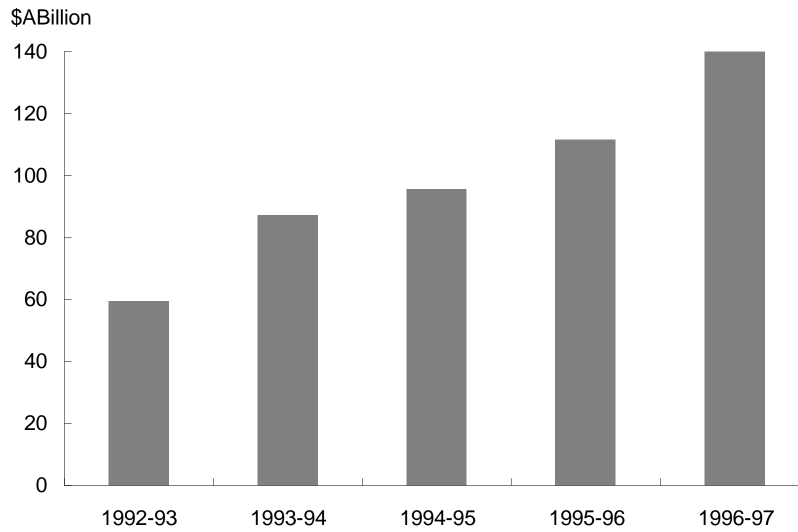
- the domination of Australian markets by institutional and foreign investors (Charts 5 and 6);

Chart 5: Ownership of Australian Share Market (March 1997)



Source: ASX 1997 Market Report.

Chart 6: Value of Foreign Investment



Source: AFMA 1997 Australian Financial Market Report.

- the emergence of alternative financial products, services and strategies which challenge traditional product and institutional boundaries. For example, Retirement Savings Accounts (RSAs) have characteristics of bank deposits and superannuation while derivatives may be used as alternatives to holding physical assets. Investors are increasingly faced with choosing between a range of products to achieve their investment goals; and
- changes in institutional structures through the rise of conglomerates which combine previously separate financial activities such as banking, securities and futures trading and insurance.[26]

The current regulatory framework for financial markets has been criticised for failing to keep pace with these changing market conditions and modern financial practices. The overlapping and fragmented regulation of financial products represents significant costs for regulators and participants as well as causing confusion among investors and some intermediaries. Given the fundamental economic function of these markets, it is critical that the objectives of market regulation are reassessed and that legislation is designed to give effect to these regulatory objectives in a cost effective manner.

3.4 Objectives of Market Regulation

The broad and somewhat overlapping objectives of financial system regulation are to promote:

- market integrity — enhance the efficiency and fairness of markets;
- investor protection — ensure investors have adequate information, are treated fairly and have adequate avenues for redress;
- enhanced competition — facilitate competition between financial service providers; and
- minimisation of systemic risk — reducing the risk that the inability of a participant in the financial system to meet its obligations as they become due may cause the failure of other financial institutions to meet their obligations.[27]

On 8 September 1997 the Treasurer released the Policy Framework which outlines the key principles underlying the CLERP review. The way in which these principles apply to the regulation of financial markets is as follows:

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26 See, for example, the *Financial System Inquiry Final Report*, p 155.
27 *Financial System Inquiry Final Report*, March 1997, pages 187-190.

Market Freedom

Free markets do not always operate in a sufficiently competitive and efficient manner. The case for regulatory intervention rests on the premise of correcting any such instances of market failure. Regulation should only modify market freedom where there are clear regulatory objectives and the benefits of intervention outweigh the costs.

The Australian investment industries are major drivers of innovation and competition which, in turn, contributes to Australia's economic development. Market regulation should facilitate the development of new products and promote competition between market providers and participants. Competition will benefit investors by providing them with diverse investment opportunities at lower cost.

It is well recognised that markets and participants benefit from fair and efficient trading environments. To this extent, internal market structures and mechanisms have been developed to enhance market efficiency and integrity. For example, adequate clearing and settlement systems have been developed by markets themselves in order to promote efficient trading practices and to reduce risk. Regulation should recognise, support, and if necessary, build upon pre-existing internal market structures. For example, regulation should promote market stability by ensuring appropriate clearing or other contract protection arrangements apply to securities and derivatives markets.

Investor Protection

Generally, investors are assumed to be the best judges of their own interests. However, retail investors in financial markets require greater protection as they may find it more difficult to, and face greater costs in, gathering the information required to make an informed decision. Conversely, sophisticated participants in financial markets have the resources to enable them to gain relevant information and have sufficient experience and judgment to protect their own interests.

The number of retail investors participating in Australian financial markets is increasing because of:

- the number of persons seeking suitable investments for their savings given the low interest rate environment;
- an increased awareness of the need to provide for retirement funding;
- well publicised large privatisations targeted at attracting retail investors to the capital markets; and

- the targeting of innovative products at retail needs; for example, the rapid growth in the warrant market.

Risk taking is a central component of financial markets. Market regulation is not intended to guarantee the success of a particular investment decision. Rather, regulation is aimed at ensuring that retail investors:

- are provided with adequate information to make informed investment decisions, particularly in light of the range of alternative products now available to retail investors;
- understand their obligations and the risks involved with particular financial products;
- have confidence in the standard and qualifications of financial market advisers and dealers; and
- are provided with appropriate avenues of redress in the event of fraud or negligence by financial intermediaries.

Information Transparency

Disclosure of relevant information will increase market integrity and efficiency by assisting markets to perform their fundamental function of pricing risk. Disclosure regulation addresses informational imbalances and increases financial market efficiency by permitting investors to make more informed decisions.

Market regulation should ensure that potential investors are informed about the nature of products and associated risks to assist in the making of investment decisions.

Cost Effectiveness

Co-regulation between a government regulatory body and an industry association is efficient as it is more responsive to market developments and places the cost of regulation directly on consumers who benefit from the regulation.[28] To this end, market operators should bear some responsibility for supervising the market, eg by monitoring compliance with market rules.

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28 *Financial System Inquiry Final Report*, March 1997, p 259.

The regulatory regime should also encourage industry and professional organisations to contribute to the development of industry best practice standards. The regulator should work with industry to develop codes of conduct, and where appropriate, delegate responsibility for competency training and testing to industry bodies.[29]

It is important to ensure that the wider objectives of regulation, such as the public interest in having efficient markets, are taken into account when developing regulatory regimes.

A more cost-effective regulatory regime will be achieved by defining the overall standards to be satisfied by market participants rather than attempting to prescribe the means of achieving those standards. This will better accommodate innovation in products, processes and industry structures. The regulatory regime should also avoid imposing unnecessary regulatory burdens on wholesale-only markets and participants.

Regulatory Neutrality And Flexibility

Regulation should be applied consistently and fairly across the marketplace as a whole. There should be minimal barriers to entry and regulation should not restrict innovation. Advantages should not be conferred on particular market structures or products unless there is a clear regulatory justification. The regulatory framework should also avoid creating regulatory distinctions which have no sound policy justification and which may result in the structuring of products or services in order to take advantage of a particular regulatory regime.

The FSI considered that technological development is one of the most pervasive influences over the continuing evolution of the financial system.[30] The impact of technology on securities and derivatives markets over the last decade is particularly striking. These markets will continue to face challenges presented by technological developments, financial innovation and integration with world markets. The regulatory framework should be sufficiently flexible to permit market participants to respond to inevitable change in an innovative, timely and sensitive manner.

Financial market regulation should not be structured around particular financial products, institutions or services as innovation coupled with technological development will quickly overtake structures which are

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29 See the *Financial System Inquiry Final Report*, recommendation 14.
30 *Financial System Inquiry Final Report*, March 1997, p 197.

considered appropriate in the current business environment. Financial innovation and the evolution of market structures is best left to the market itself, provided that transparent regulatory standards are satisfied.

A more efficient regulatory framework for the investment industry will be achieved by focussing on the functions of financial markets and products. A functional approach to regulation considers the economic functions served by financial markets and instruments and searches for the best regulatory structure to facilitate the performance of those functions. This will be achieved by focusing on activities rather than particular instruments or the nature of institutions which engage in the activities. Functionally equivalent or similar products should be afforded similar regulatory treatment.[31]

Business Ethics And Compliance

Market integrity will be facilitated if investors are confident that markets are fair, transparent and free from manipulation and abuse. Regulation should attempt to eliminate unacceptable market practices. For example, front-running of client orders, insider trading and other abusive market practices should be prohibited.

A regulatory regime for financial markets which encourages industry and professional organisations to contribute to the development of industry best practice standards will contribute to a strong compliance culture within organisations. This will enhance market integrity and investor confidence.

3.5 Overseas Experience

It is difficult to draw extensively on international experience in reassessing the regulation of financial markets given the different environments which exist in major financial centres. For example, in relation to securities and derivatives markets in the United States, regulatory responsibility is shared between the Commodity and Futures Trading Commission (CFTC) and the Securities and Exchange Commission (SEC). The United Kingdom relies on a complex self-regulatory environment. A brief outline of the United States and United Kingdom regulatory regimes is at Appendix B.

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31 Merton, *Financial Innovation and the Management and Regulation of Financial Institutions*, Working Paper No 5096.

Nevertheless, the Australian markets are part of a global trading environment characterised by cross-border capital flows and institutional investors which operate across international markets. Therefore, Australia cannot reform its market regulation in isolation from other jurisdictions and international developments.

The Government acknowledges and supports the considerable work by the International Organisation of Securities Commissions (IOSCO) and the Basle Committee in working towards strengthening the arrangements for supervision of financial markets and developing standards of international best practice. The Australian Securities Commission (ASC) is playing an important role as one of the Australian members of IOSCO. The Chairman of the ASC, Mr Alan Cameron, has recently been appointed Chairman of the IOSCO Joint Forum, a group that brings together supervisors on banking, insurance and securities. The ASC will also be hosting the IOSCO Annual Conference in Sydney in 2000.

It is clear that international markets are facing the same challenges as a result of globalisation, technological innovation and the associated changes in traditional market structures and institutional boundaries. The initiatives to reform the Australian financial market regulatory framework are being watched with interest by foreign policy makers and regulators.

PART 4: FINANCIAL INSTRUMENTS

4.1 INTRODUCTION

This part considers the current regulation of securities and derivatives markets and other investment products and some of the difficulties caused by the current regulatory regimes. It proposes a new integrated regulatory regime for all financial instruments. Elements of the new regime are considered in more detail in the remaining parts of the paper.

4.2 CURRENT REGULATION OF SECURITIES AND DERIVATIVES MARKETS

The current regulation of Australia's securities and derivatives markets is largely institution and product based. Financial instruments are regulated differently depending on how the instruments are legally classified.

Market regulation draws a distinction between 'securities'[32] and 'futures contracts.'[33] Generally, financial arrangements falling within the definition of 'securities' are traded on a securities exchange, while arrangements within the definition of a 'futures contract' are traded on a futures exchange or an OTC futures market.[34] 'Derivatives' are not recognised as a distinct category by the Corporations Law and are regulated differently depending on whether they are classified as a security or a futures contract.

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32 Corporations Law, section 92 basically defines securities as shares, debentures, bonds, prescribed interests and options over these instruments.

33 The Corporations Law, section 72 provides a technical and elaborate definition of a futures contract. Basically, adjustment agreements (contracts for differences), commodity agreements and options over these two instruments fall within the definition.

34 Banks trading currency swaps, interest rate swaps, forward exchange and forward interest contracts are not regulated by the Corporations Law. Section 72(1)(d) of the Law excludes these contracts from the definition of futures contract.

4.3 PROBLEMS WITH CURRENT REGULATION OF SECURITIES AND DERIVATIVES MARKETS

The current regulation of securities and futures markets has not adequately accommodated market developments or financial innovation. The definition of 'futures contract' is widely acknowledged as unsatisfactory and the distinction between securities and futures is challenged by innovative financial products which exhibit characteristics of both types of instruments.

Inhibits Competition

The legal distinction between securities and futures inhibits competition between market providers and creates barriers to entry. Markets in innovative financial instruments which challenge the legal definitions of securities and futures provide a striking example. For example, if the ASX wishes to conduct trading in a derivative which is legally classified as a futures contract it must either:

- seek authorisation as a futures exchange; or
- seek regulations to permit the product to be traded on the ASX as if it were a securities contract.[35]

The SFE is in a similar position if it proposes to introduce a derivative which falls within the definition of a security.[36]

Regulations to facilitate the trading of financial products on an exchange require time to develop and implement. The opportunity to develop a new product in a timely manner is lost and the delay also permits competitors to take strategic action.

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35 The Law was amended in 1995 by the *Corporations Law (Futures and Securities) Amendment Act 1994* ('the Amendment Act') which commenced on 12 April 1995 to introduce a measure of flexibility in the regulation of new financial products developed by the exchanges. The Amendment Act permits the making of regulations to prescribe certain exchange traded agreements and provide a tailored regulatory regime for those agreements. The Amendment Act was an interim response designed to facilitate innovation and competition within the securities and futures industries pending the CASAC review of the current regulatory requirements for derivatives under the Corporations Law.

36 For example, as a result of *Sydney Futures Exchange Limited v Australian Stock Exchange Limited* (1995) 16 ACSR 148 (the LEPOs case) deliverable share futures and options over shares fall outside the definition of futures contracts.

Market participants have attempted to compete within the existing regulatory framework and have also structured products to take advantage of a particular regulatory regime which may create market distortions.[37]

Lack of Certainty

There is some uncertainty among market participants as to whether new financial arrangements are futures contracts or securities. An illustration of that uncertainty is provided by the recent legal action in relation to the ASX's derivative initiative, Low Exercise Price Options (LEPOs). The Full Federal Court noted that the definitions of 'securities' and 'futures contracts' are ill suited in determining the nature of a new financial arrangement.[38] Nevertheless, the product was considered to be a security, although the Court did recognise that in substance, a LEPO is very similar to a futures contract.

Traditional View

The separate regulatory regimes for securities and futures markets may be attributed to the independent development of the Securities Industry Act and the Futures Industry Act. However, there is some support for separate regulation based on the traditional view that there are fundamental distinctions between particular financial instruments.

A new regulatory distinction between 'securities' and 'derivatives' would result in more consistent regulation of derivative products (eg options, warrants and futures). The development of this distinction would be based on the traditional view that there is a fundamental difference between fundraising (securities) and risk management agreements (futures/derivatives). That is, there is a fundamental difference between the role of stock exchanges in transferring title to securities and the role of futures/derivatives exchanges in transferring price risks through contractual arrangements.

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37 For example, products may be structured to take advantage of a particular regulatory regime. It may also be possible to structure a futures contract as an option so that it can be traded on a securities exchange. It is also possible to structure products to avoid regulation. For example, swaps where payments are made on a gross rather than a net basis may not be either securities or futures contracts.

38 *Sydney Futures Exchange Limited v Australian Stock Exchange Limited* (1995) 16 ACSR 148, per Gummow J.

However, the traditional view that there is a fundamental distinction between the role of securities and derivatives markets is under challenge from a number of perspectives including that:

- derivatives are traded on both the ASX and the SFE;
- substantially similar products are traded on the ASX as securities and the SFE as futures contracts (eg ASX LEPOs and SFE deliverable share futures contracts);
- some derivatives give rise to a transfer of title to a physical asset if held until expiry (eg equity options, deliverable futures contracts);
- new financial arrangements have been developed which exhibit traditional characteristics of both 'securities' and 'futures' — eg endowment warrants which permit holders of a derivative instrument to benefit from dividends paid on the underlying security.

Commercial practice does not accord with the traditional view that securities are investment products while derivatives are risk management tools. Currently, investors use related derivatives and securities products as alternatives to achieving a particular investment strategy. For example, an investor wishing to risk capital for future profit based on movements in the price of shares has a number of choices available: to purchase the share, take an option over it, take out a warrant or buy an individual share future. In order to diversify the investment to reduce risk, the same investor may purchase a share portfolio or a share price index futures contract. All transactions represent risk-taking on the future movement of share prices.

The extent to which a person is risk averse will influence the type of financial instrument they wish to purchase. For example, some investors prefer 'safe' investments where the capital value is relatively fixed but long term returns tend to be relatively low. Others will invest in riskier investments where the expected long term return is relatively high but there is a risk of losing part of the initial capital investment. Risk can be managed in a number of ways, including portfolio diversification which allows the subdivision and broadening across a range of investments. Alternatively, instruments which limit down-side risk, like options over shares, permit a risk-averse investor to participate in profits while only risking a small premium.

The creation of a new distinction based on 'securities' and 'derivatives' does not appear to meet the policy objectives outlined in Part 3 of this paper. Regulation based on legal definitions is inherently inflexible and, in time, is likely to become redundant given the rapid changes that have been experienced in financial markets. Further, it would result in inefficiencies, as a market operator would be required to seek dual authorisation as a securities

exchange and a derivatives exchange in order to conduct trading in both types of instruments (eg shares and options over shares).

Economic Functions Of Securities And Derivatives

From an economic perspective, the creation of a new regulatory regime based on the separate regulation of securities and derivatives would be inefficient as it would regulate functionally similar products differently depending on their legal classification.

The economic functions of securities and derivatives markets are similar, notwithstanding the varying characteristics of particular instruments. As noted in Part 3, the fundamental functions of financial markets include price discovery and the management and pricing of risk. Both securities and derivatives markets perform a price discovery function through the exchange and evaluation of information.[39] Stock index futures markets now often function as the dominant price discovery mechanism for the stock market.[40]

The similar economic functions of securities and derivatives becomes clear from an examination of the intrinsic pricing links between securities and derivatives markets. The prices of an underlying asset and the related derivative contract are simultaneously determined due to arbitrage where differences in one market are quickly transmitted to related markets. The similar price behaviour between derivatives and securities markets provides investors with real alternatives to achieve investment strategies. For example, warrants may be used to achieve capital gains from an equity issue without legally owning the underlying securities. Investors commonly use derivatives as alternatives to holding physical assets.

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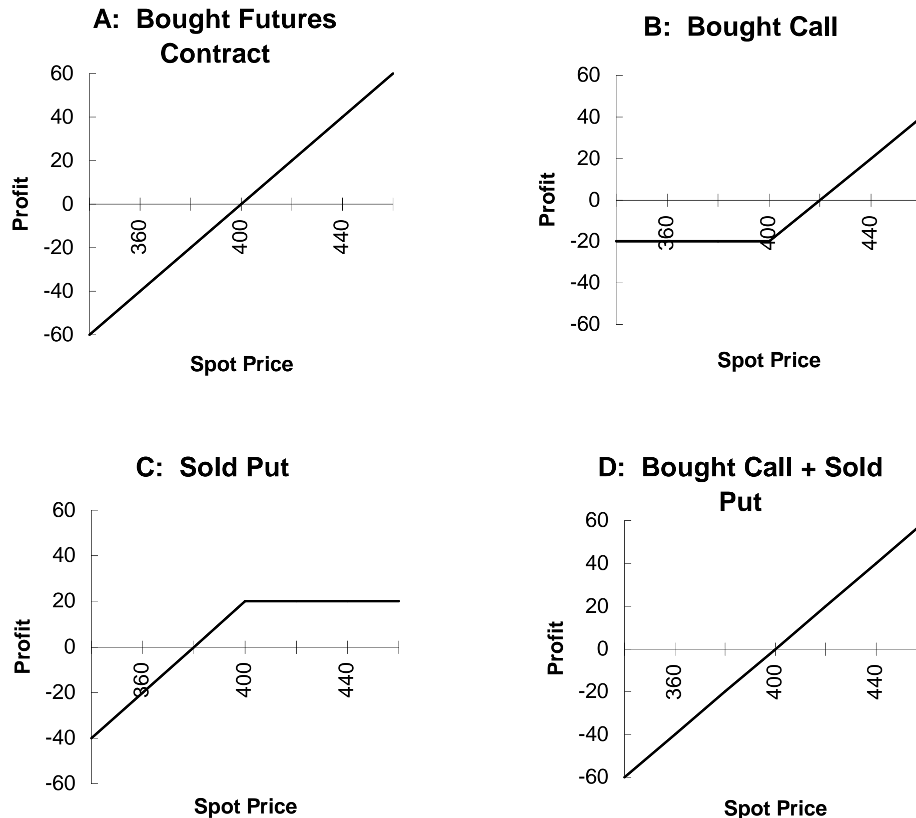
39 Currie, J.S., *Australian Futures Regulation*, Melb, 1994, p 6.

40 SEC, Market 2000, *An Examination of Current Equity Market Developments,* January 1994, p II-15.

Chart 7: Put-Call Parity



Put-call parity: A = B + C = D.

A further pricing link between securities and derivatives is illustrated by put-call parity. This pricing relationship permits investors to synthesise particular financial instruments through a combination of other instruments. Put-call parity is illustrated in Chart 7 which represents the cash flows of a bought gold futures contract for $400 and related put and call options at a $20 premium with a $400 strike price. That is, the outcome in the chart above is that the bought futures contract (A) equals the sum of a bought call (B) and a sold put (C). Represented as an equation, A = B + C = D.

Similarly, a securities position may be replicated by a position in a risk-free bond plus an equity futures contract. A bought position in a call can be replicated with a bought position in the security and a bought put. The relationship between various financial instruments means that investors may achieve their investment strategies without being confined to traditional institutional arrangements or products. For example, innovative uses of

derivative instruments may be used to achieve the same economic outcome which was previously achieved through the buying and selling of assets.[41]

4.4 CURRENT REGULATION OF OTHER FINANCIAL PRODUCTS

The regulation of other financial products is governed by various Acts and Codes of Practice.[42] As discussed in some detail in Part 5, regulation is piecemeal and varied in its regulation of intermediaries and product disclosure requirements. This results in unnecessary compliance costs for industry participants as well as additional administration costs for regulators. The different regulatory regimes contribute to investor confusion and create some uncertainty for intermediaries who must satisfy different regulatory requirements depending on the classification of the particular financial product.

The convergence between different financial products is not limited to securities and derivatives. Increasingly, investors have a choice of products available to achieve particular investment strategies, eg market linked life company products, managed investments and public offer superannuation products may all be used to achieve similar economic outcomes. The put-call parity relationship demonstrated in Chart 7 can be rearranged in a number of ways to mimic particular products.[43] Participants view particular financial products as interchangeable with, or substitutes for, other products.

Distribution of products is not confined to traditional boundaries and institutional arrangements. For example, as noted in Part 3, investors may now purchase insurance products from a broad range of institutions including life companies, life agents and brokers, banks and superannuation funds. The management of risk through guaranteeing asset values is not limited to the products offered by insurance institutions. Options and futures contracts can also be used to achieve the same economic outcome as insurance contracts. The blurring of traditional boundaries is compounded by the rise of

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41 See also Merton, *Financial Innovation and the Management and Regulation of Financial Institutions*, Working Paper No 5096.

42 For example, the ABA Code of Banking Practice, Life Circulars Nos. G.I.1 (disclosure requirements) and G.II.1 (code of practice), and the General Insurance Codes of Practice for companies and brokers.

43 For example, see Department of the Treasury, *Taxation of Financial Arrangements: An Issues Paper*, December 1996, pp 14-18.

conglomerates which combine activities which were traditionally offered by separate institutions.

4.5 FUNCTIONAL REGULATION

When considered against the underlying policy principles in Part 3, the operation of the current regulatory framework for financial markets is deficient. The inflexibility of the regulatory framework impedes innovation, inhibits competitive forces and encourages regulatory arbitrage. The current regulatory regime for financial instruments is fractured as instruments with the same economic function are regulated differently, depending on how they are classified.

Competition and financial innovation highlight the difficulties with the current regulatory regime and the need to provide a more flexible and efficient framework for financial markets. A more functional approach to the regulation of financial instruments will facilitate competition and financial innovation.

Regulation should treat economically equivalent financial instruments as elements of an integrated financial market. This position is supported by the FSI, which noted that the regulation of financial products should provide similar regulatory treatment for functionally equivalent products to promote a consistent regulatory regime.[44] A more uniform approach to financial markets regulation is supported by CASAC as well as the FSI.[45]

A functional approach to regulating financial markets and products will achieve the following regulatory goals:

- consistent regulation across products or institutions in an environment where product and institutional boundaries are blurring;
- flexibility to accommodate differences which arise between different types of financial markets and products as well as future market developments; and
- certainty to market participants and clarity to investors.

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44 *Financial System Inquiry Final Report*, March 1997, p 278.

45 CASAC, *Final Report on the Regulation of On-Exchange and OTC Derivatives Markets*, June 1997, p 46, *Financial System Inquiry Final Report*, March 1997, Recommendation 19.

4.6 HARMONISATION OF FINANCIAL MARKETS REGULATION

A more efficient and flexible regulatory regime for financial markets will be achieved by developing an integrated regulatory framework for financial instruments.

As discussed in the remaining parts of this paper, it is proposed that a large amount of the current regulation of financial markets and investment products be harmonised. For example, the proposed regime will provide uniform licensing of markets and intermediaries, and harmonise the conduct of business and market misconduct provisions.

In developing a new regulatory regime, the FSI recommendations for more uniform regulation of similar and substitute financial products will be taken into account.[46] The FSI recommended the development of consistent and comparable disclosure requirements for retail financial products (deposit accounts, payments instruments, securities, collective investments, superannuation and insurance products)[47] and a single licensing regime for securities and futures intermediaries, foreign exchange dealers, insurance and life intermediaries.[48]

The proposals in this paper regarding consistent and comparable disclosure requirements and a uniform licensing regime set out the broad policy parameters which will apply to all financial intermediaries and financial products. Further consultation with industry and the regulator will take place regarding the development of consistent administration of the disclosure and licensing regimes, harmonised remedies and enforcement mechanisms and how the proposed regulatory framework will be implemented.

4.7 REGULATORY APPROACH

Individual financial instruments have varying characteristics notwithstanding the similar economic purpose of financial products. Differences include varying risk profiles and financial obligations. However, by focussing on the

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46 *Financial System Inquiry Final Report*, March 1997, Recommendations 8, 9, 13, 15, 17, 18 and 19.

47 *Financial System Inquiry Final Report*, March 1997, Recommendation 8.

48 *Financial System Inquiry Final Report*, March 1997, Recommendation 13.

development of key criteria in the legislation which are designed to satisfy regulatory objectives it is likely that the proposed regulatory regime will accommodate these differences at a practical level, without the need for a high level of detail to be prescribed by regulation.

Similarly, the application of the statutory obligations imposed on financial advisers and brokers will vary in some instances. For example, an intermediary may be required to provide monthly accounts for funds held on behalf of clients where client accounts can fluctuate rapidly, such as where money is held for the purposes of margining requirements for derivative transactions. Less frequent reporting will be required for some other products. An intermediary which does not hold funds on behalf of clients, eg in simple insurance arrangements, will not be subject to the obligation.

The regulatory framework will prescribe key standards which need to be satisfied by persons wishing to conduct a market in financial instruments or provide broking and advisory services. In effect a person would demonstrate to the regulator that their proposed arrangements for the conduct of the market or intermediary services will satisfy these standards.

Flexibility and Market Freedom

The advantage of the proposed regulatory framework is that elements of regulation which are required for market integrity can be met in various ways. Participants will have the capacity to adopt systems and procedures which can accommodate differences between certain transactions without unnecessary prescription or other regulatory constraints. The intention is to provide maximum market freedom so that participants can design systems which accommodate their particular operations, provided that the regulatory objectives of market integrity and investor protection are achieved.

For example, an often cited difference between securities and derivatives is the longer term obligations involved in derivative instruments. Clearing arrangements for derivatives need to deal with these longer term obligations, eg through margining requirements.[49] However, rather than legislatively prescribing systems to deal with the specific risks of particular instruments, the legislation should require markets to have appropriate clearing arrangements to support their proposed activities. The nature of the proposed market activities will determine what types of clearing arrangements will be

49 Note that currently the Law does not require margining for futures contracts. Rather, the systems and procedures have been developed by market participants in order to strengthen market stability.

appropriate. Market operators may develop and adopt systems of their own choice provided they facilitate market integrity and investor protection objectives.

The proposed regulatory approach is similar to the arrangements which currently exist for the authorisation of exchanges under the Corporations Law.[50] Exchanges may be authorised if their proposed business rules make satisfactory provision for particular matters, including admission and supervision of participants and dispute resolution. The Corporations Law does not prescribe the particular rules or manner in which exchanges must satisfy the key criteria.

It would not be feasible for the Law to prescribe what systems are appropriate in particular circumstances given the varying nature of market operations, the rapid pace of change in markets and the unwarranted interference with market freedom. The regulatory framework must not constrain market participants from responding to change by developing new systems and procedures provided that the objectives of regulation are achieved.

Varying Application of Regulation

It is proposed to harmonise the current regulation of financial markets to the greatest extent possible. The broad and flexible criteria and statutory obligations proposed in this paper will vary in their application to some markets and intermediaries. It will be necessary to provide greater guidance about how some of the broad requirements will be satisfied in certain instances.

Where there is a clear need for different rules for particular markets or financial instruments, or a need to provide greater guidance on how to satisfy the legislative criteria, it is proposed that the detail may be set out in:

- regulations;
- conditions imposed on a financial intermediary's licence;
- industry codes adopted by the regulator; and
- the rules developed by market operators which are not disallowed on market integrity grounds.

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50 Corporations Law, sections 769 and 1126.

4.8. DEFINITION OF FINANCIAL INSTRUMENTS

A new definition of financial instruments will include all securities and derivatives, superannuation, life and general insurance, foreign exchange and deposit accounts and will be based on the UK Financial Services Act definition of 'investments'. It will also draw upon the considerable work undertaken by CASAC in developing a definition of 'derivatives' to replace the unsatisfactory definition of 'futures contract'. An indicative list of the types of instruments which will be included in the new concept of 'financial instrument' is at Appendix C.

A regulation making power to extend or restrict the definition is proposed in order to provide flexibility. This is required to accommodate financial innovation and to ensure the regime does not extend beyond its intended scope.

4.9 ADVANTAGES OF HARMONISED REGULATION

Benefits of a uniform regime for the regulation of financial instruments include:

- simplification of the regulatory framework for the trading of financial instruments by removing unnecessary legal distinctions;
- increased opportunities for competition and financial innovation without the need to seek dual regulatory authorisation (eg as a stock market and a futures market or dual licences to provide advice on securities and life products) and the removal of incentives for regulatory arbitrage; and
- creating flexibility that will accommodate inevitable change and permit market participants to respond in a timely manner to market developments.

Proposal No. 1 — Uniform Regulation of Financial Instruments

A more efficient and flexible regime for financial markets and investment products will be achieved by developing an integrated regulatory framework for financial instruments. The new regulatory regime will provide consistent regulation of functionally similar markets and products.

Financial instruments will include all securities, futures and other derivatives as well as foreign exchange, superannuation, general and life insurance and deposit accounts (see Appendix C).

The existing diverse regulatory arrangements for financial markets and investment products under the Corporations Law, the Insurance (Agents and Brokers) Act, the Insurance Contracts Act, the Banking Act, the Superannuation Industry (Supervision) Act and various industry codes will be harmonised.

PART 5: HARMONISING REGULATION — EFFICIENCY AND CONSISTENCY

5.1 INTRODUCTION

This part examines the current regulation of financial markets and intermediaries. Difficulties with the current regulatory framework include:

- the lack of consistent regulation of similar services and products; and
- overlapping regulatory regimes which impose unnecessary administrative costs on regulators and compliance costs on participants.

It is proposed to establish a new financial market licence based on a functional form of regulation over financial markets, clearing facilities and intermediaries.

5.2 CURRENT REGULATION

The regulation of financial markets and investment products basically takes four forms:

- the regulation of markets — which includes provisions governing the establishment of markets and provisions governing misconduct, such as the prohibition against insider trading;
- the regulation of clearing and settlement facilities — which includes requirements for both the initial approval and ongoing operation of clearing and settlement facilities, such as satisfactory provisions for the transfer, registration and settlement of transactions;
- the regulation of intermediaries — including initial licensing criteria as well as ongoing business conduct requirements such as the disclosure of benefits and conflicts of interest; and
- the regulation of the disclosure of product information — requirements on product issuers or promoters to supply potential investors with sufficient information to permit investors to make informed decisions.

The present regulation in all four areas is fragmented and inconsistent, as outlined below.

Financial Markets

Markets in securities and futures products are generally regulated by the Corporations Law through the exchange or exempt market provisions. Markets are currently regulated differently depending on their institutional structure. Different levels and types of regulation apply to exchange-traded markets and OTC markets.

Exchanges must be authorised by the Treasurer and must have rules which satisfy broad criteria relating to the conduct of their business, including the supervision of members.[51] Exchanges are required to submit amendments to their business rules to the Treasurer for consideration and possible disallowance.[52] A co-regulatory structure for supervision of the market is utilised whereby the exchanges are the front-line regulators of their markets subject to supervision by the Australian Securities Commission (ASC).

Some OTC markets fall outside the ambit of the Corporations Law (for example currency transactions conducted by a bank)[53] while others require an exempt market declaration by the Treasurer.[54] OTC markets are subject to less regulation than exchanges.[55] OTC markets are not generally subject to a co-regulatory structure but sometimes employ trading conventions and documentation promoted by industry associations.[56]

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51 Corporations Law, sections 769 and 1126.

52 Corporations Law, sections 774 and 1136.

53 Markets conducted by banks in currency and interest rate swaps, forward exchange and interest rate contracts are not regulated by the Corporations Law (see paragraph 72(1)(d)). Banks are subject, however, to prudential regulation by the Reserve Bank: section 11B of the *Banking Act 1959* empowers the Reserve Bank to monitor prudential matters of banks.

54 Specified stock markets may be declared exempt stock markets by the Treasurer (Corporations Law, section 771). Applications for exempt stock markets are currently assessed against ASC Policy Statement 100. Similarly, the Treasurer may declare a specified futures market to be an exempt futures market (Corporations Law, section 1127). These markets are assessed against ASC Policy Statement 70 and are confined to sophisticated participants.

55 Exempt stock and futures markets are not exempt from the entire operation of the securities and futures industry provisions. However they are subject to a much lower level of regulation (basically the market misconduct provisions).

56 See the AFMA Manual*: Standards and Guidelines for Australian OTC Financial Markets*

Exchange and OTC markets are economically interdependent and to some extent, compete with each other.[57] For example, participants in OTC derivative markets may hedge their exposure through exchange-traded contracts.[58] There are a number of current differences between exchange and OTC markets including:

- exchange markets provide a public price discovery function. Traditionally, OTC markets have not provided a public price formation process. However, technological advances are facilitating greater transparency in OTC markets;[59]
- exchanges have an anonymous trading environment supported by appropriate structures designed to reduce the risk of counterparty default including clearing and settlement facilities and resource backing. OTC markets are typically principal to principal negotiations that permit individual assessment of creditworthiness before entering into a transaction;[60] and
- derivative exchanges typically trade standardised contracts while OTC derivative markets involve individually negotiated arrangements which permit counterparties to tailor contracts.[61] However, the OTC derivatives market is becoming increasingly standardised, especially through the adoption of standard documentation.[62]

Clearing and Settlement Facilities

The regulation of clearing and settlement facilities is not consistent. Some clearing and settlement facilities for securities and futures exchanges are governed by the Corporations Law through the clearing house approval provisions.[63] Securities and futures market clearing house facilities may be authorised by the Treasurer if their rules satisfy broad criteria relating to the

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57 See the *Financial System Inquiry Final Report*, March 1997, p 283.

58 CASAC, *Final Report on the Regulation of On-Exchange and OTC Derivatives Markets,* June 1997, p 50.

59 For example, in May 1997 AFMA launched an information service for OTC financial markets which consolidates information vendor data into a set of Australian real-time data including live inter-bank rates and market benchmarks — see *AFMA Issues* No.5 June 1997.

60 Although there have been recent suggestions for facilities which would permit the anonymous matching of OTC participants in particular markets.

61 The SFE facilitates individually tailored transactions through the role it plays in exchange for physical transactions — see SFE Business Rules General By-Laws G.7.

62 CASAC, *Final Report on the Regulation of On-Exchange and OTC Derivatives Markets,* June 1997, p 71.

63 Corporations Law, Part 7.2A and Division 2 of Part 8.2.

conduct of their business, including the proper registration of securities transfers and futures contracts and the supervision and disciplining of members.[64]

In contrast, there are some financial settlement houses, such as the Reserve Bank Information and Trading System (RITS) and Austraclear, that are not subject to formal regulation. RITS is operated by the RBA and does not have any additional independent regulatory oversight. Austraclear is owned by the major banks and operates as a private and non-regulated venture. RITS and Austraclear provide different services to those provided by the ASX and SFE clearing houses.[65]

Licensing of Intermediaries

There are two broad aspects of financial intermediation: dealing in a product on behalf of a client, and providing advice to a client in relation to financial products. The requirements for initial registration for each of these purposes varies depending upon the nature of the financial product.

Dealing

Licensing requirements for dealers in investment products vary according to the nature of the particular financial product. For example the existing regulatory regimes include the regulation of:

- securities dealers, futures brokers and superannuation intermediaries under the Corporations Law;
- foreign exchange dealers under the *Banking Act 1959*; and
- life, general and foreign insurance intermediaries under the *Insurance (Agents and Brokers) Act 1984.*

The requirements for a licence under these various regulatory regimes are not consistent. For example:

- a securities dealer must satisfy specified requirements under the Corporations Law including education and experience, good fame and character, solvency, and the ability to perform efficiently, honestly and

64 Corporations Law, sections 779B and 1131.
65 See part 7.

fairly.[66] A representative of such a dealer must hold a proper authority from a licensed dealer;

- foreign exchange dealers must be able to operate in the international payments system and have operations which promote the efficient functioning of the foreign exchange market. Licence criteria include a capital requirement of $10 million and a demonstrated capacity to carry out foreign exchange dealings based on experience and adoption of appropriate risk management systems;[67]
- insurance brokers must not have been convicted of an offence involving dishonest conduct, must not be bankrupt or insolvent, and must comply with other obligations including having professional indemnity insurance;[68] and
- insurance intermediaries, other than brokers, must not arrange a contract of insurance as an agent for an insurer unless there is a written agreement between the insurer and the intermediary authorising them to do so.[69] An intermediary can only properly appoint an agent to operate on their behalf if it is specified in the written agreement.

Advisory Services

Under the current regulatory structure, different levels of regulation apply to advisory services depending on the type of product involved.

Only the Corporations Law regime requires advisers to be licensed for the sole activity of providing advice. A licence is required to provide advice in relation to shares, debentures, prescribed interests (including superannuation interests) and futures contracts which are regulated by the ASC under the Corporations Law.

A securities or futures adviser must satisfy requirements relating to education and experience, good fame and character, solvency, and the ability to act efficiently, honestly and fairly.[70] A representative of an adviser must hold a proper authority from the licensed adviser.

There is no comparable licensing of financial advisory services offered in relation to deposits in banks and non-bank financial institutions regulated by

66 Corporations Law, Part 7.3.
67 Press Release of the Treasurer, *Authorisation to Deal in Foreign Exchange*, No. 46 of 1984.
68 Insurance (Agents and Brokers) Act 1984, Part III.
69 Insurance (Agents and Brokers) Act 1984, Part II.
70 Corporations Law, Part 7.3.

the RBA and the Australian Financial Institutions Commission (AFIC) (although note that the Code of Banking Practice relates to product issuer disclosure and ongoing advisory requirements, rather than the licensing of advisers).

Similarly, there is no requirement to be licensed merely to provide general advice in relation to life or general insurance products (note the *Insurance (Agents and Brokers) Act 1984* only requires the registration of insurance brokers and other intermediaries who *arrange* contracts of insurance). Also, while there is no requirement to be licensed, anyone giving specific advice relating to life or general insurance would need to comply with the conduct prescribed in the respective Codes of Practice (see below). It is current industry practice that persons providing advice in relation to life and general insurance also arrange contracts of insurance. As such, they are either licensed directly as insurance brokers, or indirectly as the agents of a broker or a company.

Business Conduct of Intermediaries

After the initial licensing process, financial intermediaries are subject to different levels of ongoing conduct regulation.

Table 2 provides a broad indication of the types of conduct with which some of the various financial market intermediaries must comply.

Product Disclosure

The current regulation of point of sale product disclosure varies according to whether the investment products are classified as:

- a security regulated by the ASC under the Corporations Law — securities includes shares, debentures and prescribed interests such as public unit trusts. A prospectus is aimed at ensuring that potential investors have access to the information they would reasonably require for the purpose of making an informed investment decision;[71]
- superannuation or life insurance products, regulated by the Insurance and Superannuation Commission (ISC); and
- bank deposits, regulated by the Australian Bankers' Association's Banking Code of Practice.

Table 3: General Disclosure Obligations of Various Financial Products

Type of Product	Source of Disclosure Obligation	Content of Disclosure Obligation
Securities	Section 1022 of the Corporations Law.	A prospectus must be issued containing all the information investors and their advisers would reasonably require and reasonably expect to find to make an informed assessment of the security including: • the financial position and prospects of the issuer; and • the rights attaching to the securities.
Futures	Section 1210 of the Corporations Law (see prescribed Form no. 804)	A risk disclosure statement must be issued to all prospective clients, warning the client of the risky nature of trading futures contracts and the possibilities of large losses due to the high degree of leverage.

71 Corporations Law, section 1022.

Table 3: General Disclosure Obligations of various Financial Products (Continued)

Type of Product	Source of Disclosure Obligation	Content of Disclosure Obligation
Life Insurance	Life Circular GI1.	A key features statement must be prepared which is no more than six pages long and contains prescribed information such as: • the obligations and risks associated with the product; • details of premiums and investment options; and • when benefits are payable.
Superannuation	ISC Determination under s153(4) of the *Superannuation Industry (Supervision) Act 1993.* Regulation 2.10 under the *Superannuation Industry (Supervision) Act 1993.*	A key features statement must be prepared which is no more than six pages long and contains prescribed information such as: • information about the fund and its main objective; • rules about contributions; and • an outline of the benefits. Public offer funds must provide general and specific pre-sale information to non-standard employer sponsored members. In addition to the key features statement, trustees must provide all information that a person would reasonably need to: • understand the main features of the fund or sub-plan; • make an informed judgement about the management and financial condition of the fund or sub-plan; and • make an informed judgement of the investment performance of the fund or sub-plan.

Table 3: General Disclosure Obligations of various Financial Products (Continued)

Type of Product	Source of Disclosure Obligation	Content of Disclosure Obligation
Retirement Savings Accounts	Part 2 of the Regulations under the *Retirement Savings Accounts Act 1997.*	There is no general disclosure requirement for RSAs, but specific information must be disclosed including: • contact details of the RSA provider; • a summary of fees and charges; • an outline of the lower risk/return nature of RSAs on possible benefits in the long term; and • any fixed/variable rate options.
Bank Deposits	ABA Code of Banking Practice	Specified matters must be disclosed including: • fees and charges; • the method by which interest is calculated; and • the frequency of interest payments.

5.3 Problems with Current Regulation

Competition

OTC markets are subject to substantially less regulation compared to exchanges. This places exchanges at a competitive disadvantage to OTC markets. Some participants may artificially structure products and markets to take advantage of a less regulated environment. This results in regulatory arbitrage which artificially distorts the market.

Delay will be experienced where exchange developments require legislative modification.[72] Opportunity costs add to the greater cost associated with a higher regulatory burden.

72 Both the amendment of legislation and the development of regulations are time consuming processes.

Neutrality

Similar financial services are currently regulated differently or, sometimes, not at all. For example, the current regulation of financial advisers is confined to securities and futures products. Financial advisory services offered in relation to a number of other products, such as bank and insurance products are not subject to regulation although some are subject to product disclosure requirements.

Barriers To Entry

While retail investors are generally restricted from entering OTC markets,[73] some have shown an interest in entering certain OTC markets, particularly those relating to commodity markets. For example, wool growers have expressed an interest in entering markets which provide more accurate hedging of risk through individually tailored contracts.[74]

New Market Structures

The current regulation of financial exchanges reflects the traditional membership structure, where individual members and member firms have an ownership interest in the exchange and trade directly on the exchange floor. Historically, stock exchanges developed as a means of providing an efficient market structure where bids and offers could be channelled to a physical central market. Regulation based on this traditional structure does not accommodate new market structures, for example, where institutions have direct trading access. The difficulties with the regulatory framework in accommodating change are also demonstrated by the need for legislative amendments to facilitate the ASX proposal for demutualisation.[75]

The traditional distinction between OTC and exchange-traded markets is being challenged by technological developments. For example, the FSI acknowledged that technological developments make it possible for an OTC

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73 See ASC Policy Statement 70.

74 Macquarie Bank was granted an Exempt Futures Market Declaration on 7 October 1997 to conduct a market in wool futures contracts. Retail participation is permitted subject to compliance with conditions designed to protect these investors.

75 See *Corporations Amendment (ASX) Bill 1997* which was passed by Parliament in November 1997.

market to offer centralised trading platforms that could compete directly with exchanges.[76]

Innovative financial services driven by technological developments are also blurring the distinction between exchanges, OTC markets and financial intermediaries. Existing markets are changing character and new forms of markets are evolving. Technological innovation has enabled new and diverse trading systems to evolve which are not limited to a traditional physical marketplace. Alternative trading systems like Instinet and Posit are calling into question the traditional distinction between markets and intermediaries across the world.

The blurring of distinctions as a result of technological and financial innovation is a major factor driving review of market regulation in major world markets.[77] A striking example is provided by the cross border co-operation and competition between European exchanges. The prospect of the European Monetary Union, combined with technological developments, is resulting in mergers between some European securities and derivative exchanges.

The existing regulatory regime has not adequately accommodated the development of these new market structures.

Increased Costs

The Financial System Inquiry notes that current regulatory arrangements involve overlapping regulation of market dealers and advisers including:

- RBA licensing of foreign exchange dealers;
- ASC licensing of securities dealers and futures brokers;
- ASC licensing of investment advisers and futures advisers;
- ASC licensing of superannuation intermediaries;
- ISC registration of insurance brokers and foreign general insurance agents; and
- ISC regulation of life company supervision of life agents.

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76 *Financial System Inquiry Final Report*, March 1997, p 281.

77 Eg see the Securities and Exchange Commission, *Regulation of Exchanges, C*oncept Release, 1997.

The current point-of-sale disclosure obligations differ significantly according to the nature of the investment product. A market participant which offers two products which are subject to different regulatory regimes may have to comply with significantly different disclosure requirements.

The inconsistencies between the various regimes and the presence of numerous regulators result in:

- unnecessary compliance costs to the industry participants (eg duplication of filing and other liaison costs); and
- unnecessary administration costs to the regulators and therefore to the public.

In relation to superannuation and products regulated by the Corporations Law, the ASC and ISC have recently embarked on a joint exercise which has led to significant harmonisation of current requirements. However, there remains a number of differences between the two regimes which can be addressed only through law reform. In any event, consistent regulation for similar financial products will require significant legislative reform.

Investor Confusion

The differences between the requirements under the various disclosure regimes may lead to investor confusion. This is particularly relevant given:

- the increase in direct marketing of investment products;
- product blurring; and
- greater participant in investment markets by retail investors.

5.4 Proposal for Reform

The following FSI and CASAC recommendations are relevant in developing proposals for reform:

- a consistent and comparable disclosure regime should be developed for all retail investment products (FSI Recommendation 8);
- a single licensing regime should be introduced for financial sales, advice and dealing (FSI Recommendation 13, CASAC Recommendation 13);
- prohibitions on retail participation in OTC derivatives markets should be discontinued (FSI Recommendation 20, CASAC Recommendation 2);

- there should be a single authorisation procedure for financial exchanges and operators of a financial market (FSI Recommendation 21, CASAC Recommendations 9 and 10);
- regulation of exchanges should not be excessive compared with OTC markets (FSI Recommendation 22);
- OTC markets should be regulated through the intermediary licensing regime (FSI Recommendation 23, CASAC Recommendation 21); and
- clearing houses should be appropriately authorised (FSI Recommendation 24).

The recommendations of CASAC and the FSI are generally supported and have been used to form the basis of the proposals outlined below.

Functional Regulation

The blurring of the traditional distinctions between OTC markets, exchanges and intermediaries points to the need for more comparable regulatory treatment of similar market services regardless of the way in which those services are structured, the nature of the institution offering the service, or the nature of particular products.

A functional approach to regulating financial markets and investment products will achieve the following regulatory goals:

- regulating consistently across products and services;
- providing flexibility to accommodate differences which arise between different types of service providers and to facilitate financial innovation; and
- promoting commercial certainty to market participants and provide clarity to investors.

In order to achieve the policy objectives of neutrality and flexibility, it is proposed to provide a regulatory regime which is not based around particular market structures or investment products. This will remove the need to provide a high level of prescription to accommodate various differences between markets and products, which would ultimately lead to inflexibility and impose unnecessary constraints on market participants.

A more functional regulatory regime will be provided by considering the nature of activities conducted by market participants and developing key legislative standards or criteria which must be achieved in order to provide the

financial service. The manner in which these standards will be satisfied will vary according to the nature and extent of the proposed financial activities.

Therefore, rather than creating a regulatory regime based on the current structure of institutions, the new regulatory regime will focus on the activity or function provided by a particular market participant. The regime will be based on regulatory objectives outlined in Part 3, namely market integrity, investor protection and enhanced competition.

This will provide greater flexibility for future market developments by not restricting the form in which a market may be conducted. Market structures are continually evolving and changing. It is important that diverse markets are permitted to evolve and compete provided that regulatory standards are satisfied. Regulation should not seek to preserve particular institutions or structures. Rather, it should focus on maintaining regulatory objectives such as market integrity and investor confidence.

The New Regulatory Framework

The current Corporations Law categories of exchanges, exempt markets and securities and derivatives advisers and dealers will be replaced with categories based on 'market operation' and 'financial intermediation'. This will provide the basis for regulation of all financial markets and investment products.

Single Financial Market Licence

To facilitate similar and consistent regulation of comparable financial products and services, it is proposed that a single financial market licence with various categories will be developed.

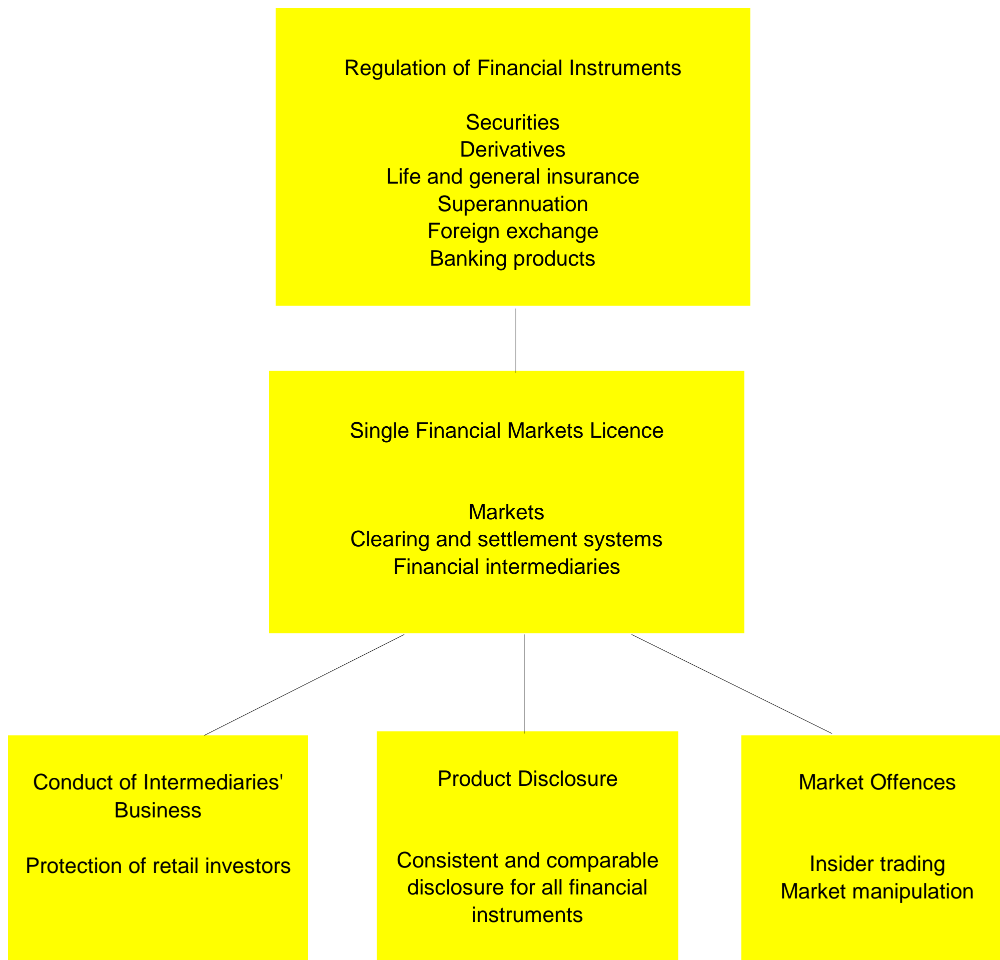
A person will be prohibited from conducting a business in financial instruments without a financial market licence. The licence will have three categories which are based on a functional approach to market activities:

- a licence to operate a market facility;
- a licence to operate a clearing and settlement facility; and
- a financial intermediary's licence.

Financial markets and intermediaries will be subject to harmonised rules regarding product disclosure, conduct of business and market offences. It is proposed that regulations or the rules of market operators set out more

detailed requirements where there is a clear need to provide different rules to accommodate particular markets or financial instruments. Greater guidance about how the statutory obligations of intermediaries will be satisfied in certain instances may be provided through imposing detailed licence conditions on financial advisers and brokers as well as the development of codes of conduct by the industry and the regulator.

Chart 8: New Regulatory Framework



Elements of the new regulatory framework for financial markets and investment products will include:

Markets

Currently, exchanges perform a vital economic function in Australia. The ASX and the SFE provide liquid markets which are available to a broad base of investors. However, other types of markets which do not fall within the traditional exchange structure may also provide similar services in the future. Exchanges themselves need to be able to evolve in order to remain competitive.

A person who proposes to operate a market facility which involves multiple buyers and sellers (ie which matches buyers and sellers of financial instruments) would require a market operator’s licence. A distinction will not be drawn between exchanges and other types of markets in the criteria for licensing market operators. Rather, it will set out broad principles which must be satisfied before a licence will be granted. The way in which the broad legislative criteria will be satisfied will differ according to the nature of the proposed market activities.

Market offences, including prohibitions against insider trading, will be harmonised.

Clearing and Settlement Facilities

Clearing and settlement facilities perform important functions for financial markets. Clearing and settlement facilities may operate as part of a licensed market facility or operate independently. In either circumstance, clearing and settlement systems should satisfy minimum threshold criteria before being permitted to operate.

Intermediaries

Uniform licensing criteria will apply to all financial intermediaries including superannuation, life and general insurance, foreign exchange, securities and derivatives brokers and advisers. Services which will require an intermediary’s licence include:

- dealing in financial instruments;
- providing advice about financial instruments;
- managing investment schemes and providing custodian or depository services; and

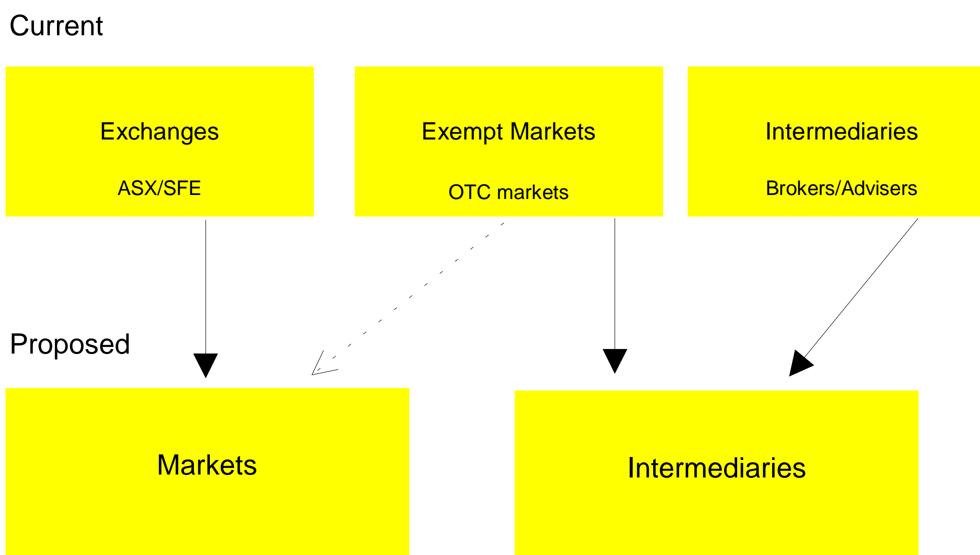
- holding out that the person is willing to enter into either side of a financial instrument transactions as a principal — ie professional intermediaries which act as a counterparty to every transaction (OTC market making).

Harmonised conduct of business requirements will be imposed on intermediaries aimed at providing appropriate protection for retail clients. Enforcement mechanisms will be harmonised to ensure consistent application of the regime.

As shown in Chart 9, the majority of activities conducted under the exempt market provisions will fall within the new financial intermediaries category. Generally, there is no central marketplace or facility which matches buyers and sellers in the exempt OTC markets. Rather, the majority of current transactions are bilaterally negotiated between institutions and professional dealers which deal through telephone and computer systems. The standards to be satisfied by an intermediary which proposes to provide these services will be reflected in the licence criteria.

Some activities which currently fall within the exempt market provisions will be regulated under the market operator provisions — eg multi-lateral markets conducted in specific securities (represented by the dotted arrow). The proposed distinction between markets and intermediaries is aimed at distinguishing between multi-lateral markets which match buyers and sellers of financial instruments and services provided by intermediaries which are always counterparties to every transaction.

Chart 9: Current Distinctions under the Proposed Regulatory Regime



There may not always be a clear distinction between services provided by a market operator and a financial intermediary. Some services offered by intermediaries may provide similar functions to those performed by markets. However, the criteria for each category of the proposed financial market licence is based on regulatory objectives which should result in comparable regulation of similar activities. The administration of a single licence by one regulator may also assist in providing comparable regulation of similar services and may eliminate uncertainty by providing flexibility in relation to which category of licence is appropriate for particular financial services.[78]

Product Disclosure

It is vital that investors be supplied with clear and comprehensible information in a form which enables retail investors to make informed decisions and to assess the respective merits of different financial instruments. A consistent regulatory regime governing product disclosure, regardless of which institution offers the product, will assist investors to compare similar investment products. Information provided to investors must set out the basic features of an investment product including risks, fees and charges.

78 See Part 12.

5.5 APPLICATION OF PROPOSED REFORMS

All financial market participants who commence operation following adoption of these reforms will be required to comply with the new requirements.

Existing financial market participants that are currently regulated under various Acts including the Corporations Law, the Life Insurance Act and the Insurance (Agents and Brokers) Act will have a period of 2 years to gain a new licence under the new requirements. Transitional arrangements will apply until an existing participant gains the necessary licence under the new requirements.

The integrated nature of the proposed reforms will be enhanced by requiring existing participants to seek a licence under the new regulatory regime. The alternative approach would be to grandfather existing market participants so that they are not required to seek re-authorisation under the new regulatory regime.

It is envisaged that existing exchanges, clearing and settlement facilities, exempt markets and financial intermediaries would clearly satisfy the proposed criteria for the various categories of the financial market licence. The re-authorisation process will, however provide an opportunity for existing participants to reassess their operations under the current fragmented and inefficient regulatory regime and to respond to the opportunities presented by the new regulatory framework.

Proposal No. 2 — New Regulatory Framework

Persons will be prohibited from conducting a market in financial instruments or providing financial intermediary services unless they hold an appropriately endorsed financial markets licence. The financial markets licence will have three categories:

- a licence to operate a market facility;
- a licence to operate a clearing and settlement facility; and
- a licence to provide financial intermediary services.

The criteria to be satisfied in order to obtain a licence will be broadly stated and flexible to accommodate different market structures, investment products and financial intermediary services. The way in which these legislative requirements will be satisfied will vary according to the nature of the services provided.

PART 6: MARKET FACILITIES

6.1 INTRODUCTION

In order to facilitate market integrity and investor confidence in the efficient operation of market facilities, a market operator must be licensed to ensure it satisfies threshold licensing criteria.[79]

6.2 WHEN WILL A MARKET OPERATOR'S LICENCE BE REQUIRED?

A licence will be required where a person proposes to provide a market facility:

- where financial instruments are regularly traded or information is provided about the prices at which persons may expect to trade financial instruments; and
- which involves multiple buyers and sellers.

This category of financial market licence is only intended to apply to persons who conduct a business of providing facilities for the matching of buyers and sellers of financial instruments. The matching may take place at the best bid or offer or at a price between the best bid and offer.

It is likely that, for the present time, a market operator's licence will only be required for markets in securities and derivatives. However, markets in other financial instruments may emerge in the future. The proposed regulatory regime provides flexibility which will accommodate financial innovation including the possible evolution of markets in new instruments or innovative ways of distributing existing financial products.

Persons carrying on a business of providing intermediary services in relation to financial instruments, which do not involve the operation of a market, will

79 See the objectives of regulation in Part 3.

require a financial intermediary's licence. Most of the activities currently falling within the exempt market provisions of the Corporations Law will require a financial intermediary's licence rather than a market operator's licence.

Certain activities will not fall within the proposed ambit of activities which will require a market operator's licence, for example buyers and sellers of financial instruments, treasury operations within a corporate group, and cross-trading between collective investment schemes which have the same fund manager.

6.3 CRITERIA FOR MARKET OPERATOR'S LICENCE

A person who proposes to conduct a market in financial instruments must demonstrate that they are able to operate the market in a fair and orderly manner. The key criteria which a market operator must satisfy include that the market operator:

- has adequate arrangements regarding supervision of the market;
- must have and maintain sufficient resources to conduct the market and carry out supervisory functions;
- has adequate rules or procedures relating to the operation of the market, including access to market facilities, the recording and disclosure of transactions effected on the market and procedures for dealing with complaints;
- has adequate arrangements for the clearing and settlement of transactions; and
- has adequate protection for retail investors.

The broad and flexible criteria will accommodate different market structures and varying services. The way in which these requirements will be satisfied will not be prescribed and will vary according to the nature of the services provided by the market operator. Market operators will be given maximum freedom to adopt systems and procedures of their choice provided they satisfy the regulatory objectives of market integrity and investor protection.

It is proposed to retain the regulatory arrangements contained in the Corporations Law Amendment (ASX) Bill to ensure that the objectives of market regulation are satisfied by the market operator on a continuing basis. SRO functions should be retained and maximised to the greatest extent possible, subject to enhanced accountability mechanisms to ensure that

regulatory responsibilities are discharged by market operators and that the market operates in the public interest. These mechanisms would include imposing statutory ongoing obligations on a market operator to conduct a fair and orderly market and to supervise and enforce compliance with the market rules and the regulatory requirements. The market operator would be required to report annually on compliance with these requirements and may be required to provide special reports at any time. It is proposed that a market operator may be directed to comply with the statutory requirements if it fails to meet these obligations.

It is proposed that market operators be required to submit amendments to their operating rules for possible disallowance on market integrity grounds.

The following sections consider some more specific issues in relation to licensing markets.

Market Supervision

Appropriate supervision of markets will contribute to investor confidence and market integrity. The objectives of market regulation must be satisfied on a continuing basis. Therefore, compliance with market rules and procedures must be monitored. Supervisory obligations imposed on a market operator are aimed at enforcing the statutory obligations as well as market rules and procedures. The legislative framework will provide appropriate powers to a market operator to enforce the market rules and procedures.

The way in which the supervision of markets will be satisfied will vary according to the nature of the market. For example, some market operators may appoint an independent supervisor to report on compliance with the legislative requirements and market procedures.[80] Other markets may require a self regulatory structure similar to the supervisory responsibilities carried out by the ASX and the SFE. It is proposed to retain these SRO arrangements where the exchanges are the front line regulators of their markets.

It is proposed that the regulator retain the overall regulatory responsibility for market supervision by conducting periodic audits of the effectiveness of SRO supervision arrangements. A market operator must report annually on its compliance with the ongoing obligations including its supervisory functions.

80 See section 770A of the Corporations Law.

Resources

A market operator must have adequate resources to fund the establishment of the market and the ongoing costs of conducting the market, including effective supervision of the market. Market operators may satisfy this requirement through different means depending on the services provided. 'Adequate resources' is not limited to financial resources, and may include obligations to ensure appropriate human resources and computer systems.

Clearing and Settlement

Clearing and settlement arrangements associated with financial markets contribute to the efficient operation of the markets and promote investor confidence. It is vital that these arrangements operate effectively, particularly where systems are designed to minimise the risk of default through providing protection against third party credit risk.

Clearing and settlement services may be conducted by the market operator or an associate, or undertaken by an independent clearing and settlement facility. All services will be assessed against the criteria outlined in Part 7. Services conducted by the market operator or associate will be assessed as part of the application to conduct a market. Independent facilities will require a clearing and settlement licence.

The nature of the activities conducted by the market operator will impact on the types of clearing and settlement arrangements which must be provided in conjunction with the market in order to satisfy this requirement. For example, 'anonymous' trading environments, where parties do not know the identity of counterparties before contracting on the market, will require a system which provides protection against counterparty credit risk. This type of trading environment will require some form of novation clearing or credit capping in order to satisfy the market operator criteria. However, it is proposed that this level of prescription not be contained in the legislation.

Some markets may not offer clearing or settlement services. For example, the market operator may merely provide information about the price of financial products or simply match buyers and sellers who settle through private negotiation. In these circumstances, the market operator would be required to disclose that the settlement is the responsibility of the individual parties.

Protection of Retail Investors

Intermediaries which participate in markets which are open to retail investors must have appropriate mechanisms to provide protection against loss caused by fraud or negligence. For example, intermediaries may be required to obtain indemnity insurance or collectively provide compensation arrangements through a fidelity fund.

6.4 MARKET FRAGMENTATION

Competition plays a central role in driving market responsiveness and efficiency by facilitating reductions in costs and the development of innovative systems and products. Recent proposals to establish markets which will compete with existing markets in Australia have raised issues as to whether markets offering identical products should be permitted to be established.[81] An increasingly global marketplace and the evolution of alternative screen-based markets increases the prospects of competition for Australian established markets.

Given the general benefits provided by competition, the development of competing markets should not be hindered unless there are overriding regulatory objectives.

The development of competing markets in identical products raises an issue as to whether it will cause detriment to the Australian market by creating market fragmentation. This issue is particularly relevant for a small to medium sized economy such as Australia. A directly competing market may impair the price formation process by diffusing order flow across two different markets and complicate the monitoring and surveillance of the trading of the particular product.

Market fragmentation can arise from the segmentation of a market between geographic places or between tiers of investors. By diffusing trading through different markets, fragmentation could adversely affect the price formation process. Price discovery is reliant on information, including on previous and most recent trading, to determine market demand and supply and hence prices. Price discovery is equally dependant upon market turnover or liquidity.

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81 See *Sydney Futures Exchange Equity Options*, Treasury Discussion Paper, September 1996.

These possible detriments are not an inevitable result of market segmentation. Rather they depend on whether there is an accompanying overall reduction in the quality, amount or timeliness of information available to traders. In particular there may be offsetting benefits of competition including improvements in communications and the development of more efficient trading systems. The FSI noted that although the operation of markets in the same financial products raises complex policy issues, this should not prevent the entry of new markets.[82]

Technological developments have greatly enhanced the transfer and availability of information which has impacted positively on the price discovery process. Effective access to information rather than market structure *per se* — and in particular the physical co-location of traders — are now acknowledged as key factors for market efficiency. This reinforces the importance of regulation aimed at promoting effective information disclosure as well as ensuring that regulation is applied consistently across the marketplace as a whole.

Therefore, competing markets should be permitted provided that there is effective disclosure of information to promote transparency and the price formation process across a dispersed marketplace. Market systems should promote the exchange of information between competing markets and their participants as well as provide effective arrangements for cross-market monitoring and supervision as well as any other regulatory issues.

6.5 Competition Issues

The Treasurer's announcement of the Government response to the FSI recommendations stated that the ACCC will be retained as the economy wide competition regulator for the financial system.[83] Market operators who propose to adopt practices inconsistent with the Trade Practices Act must seek appropriate authorisations from the ACCC.[84] This may involve the requirement for market operators to seek ACCC authorisation for an amendment to its market rules as well as seek non-disallowance of the rule.

The Government agrees with the FSI that the ACCC's competition role is separate to the market integrity role undertaken in the non-disallowance

82 See the *Financial System Inquiry Final Report*, March 1997, p 281.
83 *Financial System Inquiry Final Report*, March 1997, recommendation 80.
84 The ACCC may authorise anti-competitive arrangements under section 88 of the Trade Practices Act.

examination.[85] However, the FSI recommended that there should be appropriate co-ordination in examining the competitive and market integrity consequences of rule.

Proposal No. 3 — Market Facilities

A licence to operate a market will be required if a person proposes to provide a market facility:

- where financial instruments are regularly traded or information is provided about the prices at which persons may expect to trade financial instruments; and
- which involves multiple buyers and sellers.

The criteria to be satisfied to obtain a licence to conduct a market facility will be that the market operator must:

- have adequate arrangements for the supervision of the market;
- have and maintain sufficient resources to conduct the market and carry out supervisory functions;
- have adequate rules or procedures for the operation of the market, including access to market facilities, the recording and disclosure of transactions effected on the market and procedures for dealing with complaints;
- have adequate arrangements for the clearing and settlement of transactions; and
- have adequate protection for retail investors.

The legislation will set out the ongoing obligations which will be imposed on a market operator to ensure that the objectives of market regulation are satisfied on a continuing basis.

85 *Financial System Inquiry Final Report*, March 1997, recommendation 5 and p 253.

PART 7: CLEARING AND SETTLEMENT FACILITIES

7.1 INTRODUCTION

Clearing houses play an important role in the efficient functioning and successful operation of financial markets. They may take on major financial risks in guaranteeing the fulfilment of transactions and providing protection against counterparty credit risk.

In order to promote efficiency and investor confidence in the effective clearing and settlement of financial market products and payment obligations a facility must be licensed to ensure that it meets minimum threshold criteria. The objectives of regulating clearing and settlement facilities are based on market integrity and prudential grounds.[86]

7.2 NATURE OF CLEARING AND SETTLEMENT FACILITIES

There are five principal clearing and settlement facilities operating in Australia. These are:

- transactions effected on the SFE are settled and cleared through its subsidiary, SFE Clearing House (SFECH);
- the ASX equity transactions settlement system is operated by the ASX Settlement and Transfer Corporation. CHESS, the Clearing House Electronic Subregister System, records the equity transfers of ASX members and determines the resulting settlement obligations which take place through the payments system;
- the ASX wholly-owned subsidiary, the Options Clearing House (OCH), clears all options transactions on the ASX operated Australian Options Market (AOM). The OCH registers all options contracts traded on the

86 See the objectives of market regulation in Part 2.

AOM, calls for margins and deposits, and maintains a depository for the lodgment of scrip and bank guarantees against sold call option positions in the market;

- the Reserve Bank Information and Transfer System (RITS), which transfers and provides settlement of Commonwealth Government Securities (including Treasury Bonds); and
- Austraclear which is jointly owned by the large Australian financial institutions and was established to facilitate trading in money market securities. Austraclear provides a central registry and depository for the money market and fixed interest securities, and operates a system for the electronic transfer of the ownership of debt securities without the need for physical transfer.

7.3 Types of Clearing and Settlement Facilities

The nature of clearing and settlement services varies according to the features of the financial product and the way in which the product is traded. For example, derivative products generally involve long term financial commitments and obligations prior to final settlement while equities are settled relatively quickly. An anonymous trading environment for financial instruments will require different clearing and settlement services to systems where counterparties assess credit risk before entering into a transaction. Clearing and settlement facility operations and procedures will vary in order to provide appropriate support for these different types of markets and products.

The major types of clearing and settlement arrangements utilised in financial markets are outlined below.

Payments Clearing

Payments clearing involves the processing of payment instruments followed by account reconciliation. The Australian Payments Clearing Association (APCA) currently provides the framework for Australia's payments system which is divided into four streams — paper, bulk electronic, consumer electronic and high value payment systems. Austraclear currently provides a clearing system for wholesale financial markets outside the APCA framework.

The Government response to the FSI recommendations stated that the RBA, through the creation of the Payments System Board (PSB), will be responsible for the regulation of payments clearing.

Novation Clearing

Novation clearing occurs where the clearing house becomes a party to each registered contract and breaks the link between the original contracting parties. That is, the clearing house enters into substitute contracts with each of the original counterparties (the clearing house members rather than their clients), becoming the seller to the buyer and the buyer to the seller. Full counterparty credit risk is transferred to the clearing house and the obligations of each contract will be fulfilled notwithstanding the default by the original counterparty. This system permits parties to trade in an anonymous environment by removing the requirement to assess counterparty credit risk before transacting in the market.

The concentration of risk in the clearing house is magnified in derivatives trading where the financial obligations of each party change with movements in the market. In order to control credit risk the clearing house imposes capital adequacy, position limits and margin requirements on its clearing members. Clearing houses may maintain a clearing guarantee to provide protection against the risk that a clearing member may fail to meet its obligations and leave the clearing house unable to meet obligations. Close out powers may also be exercised in the event of default.

SFECH and the OCH currently use novation clearing in relation to derivatives traded on the SFE and the ASX. Under CHESS most market transactions (that is, those resulting from the Stock Exchange Automated Trading System (SEATS) matching bids and offers or otherwise recorded by SEATS) are novated under the Securities Clearing House (SCH) business rules. Payment and securities transfer obligations are calculated and set off, resulting in a single net payment to or from each broker and a single net transfer in each class of securities to or from the broker.

Title Transfer Clearing

Title transfer clearing involves the recording, clearance and settlement of transactions. The clearing house does not become a party to the transaction. Under the Austraclear system, unlike the clearing houses of futures exchanges and options markets, Austraclear does not become a party to contracts made between members. The Austraclear system allows members transacting with

each other to coordinate with their banks concerning payment obligations on their behalf. Once the banks have notified that they will meet those obligations, any required transfers between the exchange settlement accounts of the banks are notified to the RBA and any related securities elements are settled. The RITS system operates in a similar manner.

Alternative Controls

A number of alternative clearing arrangements have been mooted for various financial markets. For example, OTC participants may wish to operate in a centralised system where each participant sets credit limits for particular counterparties. The centralised system would only match parties within the specified limits and may provide settlement services. Credit capping arrangements may be appropriate clearing and settlement mechanisms for some market facilities.

7.4 SYSTEMIC RISK

Financial markets are the source of the bulk of transactions settled though high-value settlement systems in Australia. Annual turnover in markets in foreign exchange, debt, equities and derivatives in 1997 was $33 trillion[87] which is approximately 64 times the 1996-97 Australian GDP.

Systemic concerns about market clearing facilities arise from their possible role as the counterparty and guarantor. A variety of methods are used by clearing facilities to limit their exposure and to ensure performance by their members including margining, guarantee arrangements, netting, position limits, capital and credit lines. It is vital that persons who offer clearing and settlement facilities are able to meet their obligations as well as effectively manage risk.

The October 1987 stock market crash, where there was near failure of the US Options Clearing Corporation and the Hong Kong Futures Guarantee Corporation required rescue and recapitalisation, and the failure of Barings Futures (Singapore) emphasise the counterparty risks faced by financial market exchanges. A recent survey noted that there are wide differences in

87 *AFMA Financial Markets Report*, 1997.

risk management practices, resources and regulatory environments across world markets.[88]

Market instability may disrupt the financial system. Price movements may question the viability of participants and threaten various settlement systems. Systemic concerns have been heightened by the increasing complexity of arrangements between financial market participants, particularly the global nature of trading and resulting obligations. However, developments in technology have assisted in providing arrangements which control exposures and reduce counterparty risks. Examples include:

- the move towards real-time gross settement (RTGS) which reduces payments risk by irrevocably settling each high-value transaction as it occurs. RTGS will be implemented in Australia in 1998 and will cover all high-value interbank payments for transactions in government securities, fixed interest and foreign exchange and securities settled through Austraclear;
- CHESS now transfers legal title to equities against payment of cleared funds provided electronically by participants' banks;
- reducing settlement cycles — eg CHESS now operates on a trade date plus 5 business day (T+5) settlement cycle and is scheduled to move to international best practice of trade date plus 3 business days (T+3);
- bi-lateral and market netting systems; and
- evolution of better risk management and control systems for market participants based on software and technological developments.

Reforms in these areas are considered in Part 5 of the CLERP Paper No. 5 on Electronic Commerce.

The safety of clearing and settlement facilities for financial markets is an issue of international concern. In 1996 the G10 and IOSCO formed a working group to develop disclosure arrangements for securities settlements systems including requirement to disclose:

- comparative information on the rights, obligations and exposures associated with securities settlement systems;
- organisational arrangements including ownership and relationships with participants; and

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88 Moody's Investor Services 1995, *Credit Risks of Clearinghouses at Futures and Options Exchanges.*

- rules, procedures and risk control measures.

Other measures which will facilitate transparency and better risk management procedures include moves towards harmonising international accounting standards and market value and risk accounting. Harmonised accounting standards will assist in assessing counterparty risks in different jurisdictions. Market value accounting provides a more accurate reflection of the solvency of an entity while risk accounting would provide a dynamic measure of the financial standing of the entity. Reforms in these areas are considered in Parts 5 and 10 of the CLERP Paper No.1 on Accounting Standards.

7.5 FINANCIAL SYSTEM INQUIRY RECOMMENDATIONS

The FSI recommendations in relation to clearing and settlement systems include:

- a Payments System Board (PSB) should be created within the RBA which will be responsible for regulating clearing streams;[89]
- access to clearing systems should also be widened to include all institutions fulfilling objective criteria set by the PSB;[90]
- given that major participants in wholesale markets are prudentially regulated there is no need to prudentially regulate financial market intermediaries.[91] However, regulatory agencies should monitor the evolution of wholesale markets for the emergence of large institutions which are not subject to prudential regulation. If such institutions evolve the FSI recommended that these be subject to prudential regulation;[92] and
- the ACFSC should be responsible for the regulation of clearing and settlement facilities relating to financial exchanges.[93] The prudential and systemic regulatory agencies should keep abreast of these operations — the Australian Prudential Regulatory Association (APRA) and the RBA will have access to prudential information on most of the major participants in exchange-traded markets who are predominantly prudentially regulated participants. The Inquiry rejected the concept of transferring responsibility for all clearing and settlement activities to the

89 *Financial System Inquiry Final Report*, March 1997, recommendation 61.
90 *Financial System Inquiry Final Report*, March 1997, recommendation 69.
91 *Financial System Inquiry Final Report*, March 1997, recommendation 18.
92 *Financial System Inquiry Final Report*, March 1997, recommendation 58.
93 *Financial System Inquiry Final Report*, March 1997, recommendation 57.

RBA[94] as it considered that co-ordination between the regulators will address information sharing and any difficulties.

7.6 Clearing and Settlement Licence

The FSI recommendations highlight the sometimes difficult task of separating market integrity regulation from regulation designed to reduce systemic risk. It is difficult to draw a bright line distinction between exchange clearing and settlement facilities and other wholesale activities. For example, payments to SFECH are currently settled through Austraclear. Transfer of government securities to satisfy SFE listed contracts occurs through RITS. That is, Austraclear and RITS provide the delivery mechanisms for contracts requiring physical delivery of financial instruments.

Increased competition may result in third party providers competing with existing exchange facilities to clear identical financial instruments.

The Government is concerned to ensure that there is no regulatory duplication which requires clearing and settlement facilities to seek dual authorisations. It is proposed that all clearing and settlement facilities for financial instruments will require an appropriate financial market licence. However, facilities which have been authorised by the PSB will be exempt from the requirement to obtain a financial market licence.

7.7 When will a Clearing and Settlement Licence be Required?

It has been suggested that clearing and settlement services should include facilities which regularly provide mechanisms that confirm transactions, transfer the title to financial instruments, assist in the performance of obligations arising from a financial instrument transaction and ensure that parties to a transaction meet delivery and payment obligations. A person who provides these services would require a licence if the service is offered in conjunction with transactions entered into on a licensed financial market or where they are systematically provided to third parties.

94 As recommended by the SFE in its submission to the Financial System Inquiry.

All clearing and settlement facility operators will be required to be licensed, unless the facility has already been authorised as part of a licence to operate a market. A facility which is operated as part of a market will be assessed against the criteria below at the time of the application for a market licence.

A clearing and settlement facility which is regulated by the PSB will not require a financial market licence. An alternative would be to require all clearing and settlement facilities which provide services to markets or intermediaries which are licensed by the ACFSC to obtain an ACFSC licence. The Government invites comment on how regulatory responsibility for clearing and settlement facilities will best achieve the policy objectives.

7.8 Criteria for Clearing and Settlement Licence

An applicant proposing to conduct a clearing and settlement facility must demonstrate their capacity to operate the facility with the appropriate safeguards against failure. A clearing and settlement facility must:

- have adequate rules or procedures relating to the operation of the facility, including effective risk management procedures;
- have adequate arrangements for supervision of the facility; and
- have and maintain sufficient resources to conduct the facility and perform the supervisory functions.

The criteria are intended to be flexible to accommodate the broad range of different clearing and settlement facilities. Currently the practices for clearing and settlement are contained in the rules of the particular facilities rather than prescribed in legislation. Responsibility for designing appropriate systems should rest with the market operator or independent facility provider rather than the regulator, provided the systems satisfy the legislative standards reflected in the authorisation criteria.

Clearing and settlement facilities should implement world best practice where appropriate. Recent reports[95] have identified measures which represent international best practice in relation to novation clearing arrangements including:

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95 Futures Industry Association, *Financial Integrity Recommendations* (June 1995) and the Bank for International Settlements, *Clearing Arrangements for Exchange-Traded Derivatives* (March 1997).

- marking to market all open positions on a daily basis and promptly collecting resulting margins;
- imposing position limits on clearing members and their clients;
- ensuring that clearing members monitor the credit risk of their clients;
- supervision of clearing members' compliance with clearing house rules;
- providing appropriate procedures for close-out of positions of a defaulting member;
- maintaining adequate financial resources, including capital and clearing guarantees; and
- ensuring periodic stress testing to assess the implications of major price movements to ensure that resources and risk controls are adequate.

Some specific elements of the criteria are considered below.

Risk Management Procedures

The nature of the clearing and settlement service will dictate what procedures will provide appropriate risk controls. Facilities which merely record obligations and transfer funds or assets will not require the same controls as a facility which guarantees transactions and bears full counterparty credit risk. Recording facilities which do not bear counterparty credit risk would not require margining systems or close out powers for defaults.

There is an increasing range of clearing and settlement services which may be effective for various financial products and it is likely that new arrangements will emerge in the future. The legislation will not prescribe particular systems which are appropriate for varying markets. Rather, a service will meet the regulatory requirements if it satisfactorily deals with the risk presented by the nature of the clearing and settlement facility and the trading of the particular financial product. As noted in Part 6, a market facility which provides an anonymous trading environment where parties cannot assess credit risk before entering into a transaction will require some form of contract protection like novation clearing or credit capping.

Supervision

It is proposed that clearing and settlement facilities should monitor compliance with their rules and procedures, including compliance with any margining requirements, position limits and capital requirements. Effective

monitoring and enforcement of facility rules will facilitate market integrity and minimise the risk of default. The rules should provide appropriate provision for expelling or disciplining members for contraventions of the rules or the legislative requirements.

The intensity of supervision of facility participants will vary according to the nature of the clearing and settlement service. For example, novation clearing will require a high level of supervision given the concentration of risk borne by the clearing house. These systems may impose margining requirements, impose certain risk management procedures on participants and require notification of any breach of the facility rules.[96]

Resources

The level of resources which is appropriate for particular facilities will depend on the proposed operations and services. Resource requirements are designed to ensure that the facility can meet its obligations, including the requirement to supervise the facility. Mere transfer clearing will not require the same level of resources as a facility which guarantees the completion of final settlement obligations where resource backing may be drawn upon in the event of member default.

Resource backing may take various forms including levies on transactions, member contributions and external insurance. The level which will be appropriate should take into account the operation of the facility as a whole, including risk control mechanisms.

Proposal No. 4 — Clearing and Settlement Facilities

A licence to operate a clearing and settlement facility will be required where the clearing and settlement services are not conducted by a licensed market operator.

The criteria to be satisfied to obtain a licence to operate a clearing and settlement facility will be that the facility provider must:

Continued

96 For example, the SFECH rules require clearing members to notify the clearing house if their capital falls below a percentage of the regulatory minimum or if the margin obligations exceed 80 per cent of their net tangible assets.

- have adequate rules or procedures for the operation of the facility;
- have adequate arrangements for the supervision of the facility; and
- have and maintain sufficient resources to conduct the facility and perform supervisory functions.

The legislation will impose ongoing obligations on clearing and settlement facility providers to ensure that the objectives of market regulation are satisfied on a continuing basis.

PART 8: FINANCIAL INTERMEDIARY'S LICENCE

8.1 INTRODUCTION

The primary objective of regulating intermediaries is to provide protection for retail investors. Adequate licensing thresholds facilitate retail investor confidence that financial intermediaries have appropriate skills, experience and qualifications. Statutory obligations imposed upon intermediaries are designed to limit fraud and provide appropriate accounting for client instructions and funds.

A related objective of licensing financial market intermediaries is based on market integrity and prudential grounds. Financial advisers and dealers should have adequate resources to conduct their business and, in some instances, protect against the risk of contagion to other financial participants in the event of default.[97] Key elements of market integrity are reflected in the general requirement for licence holders to act honestly, efficiently and fairly.

8.2 LICENSING FINANCIAL INTERMEDIARIES

As recommended by the FSI, a single licensing regime for regulating persons who provide professional services on which users rely, such as dealing or advising on financial instruments, will be introduced.

The Corporations Law provides a model for regulating financial intermediaries who deal in and/or advise on financial products. Under this model, principals are licensed and are responsible for the conduct, training and supervision of their licensed employees and agents. Individual representatives or agents are not licensed.

This approach is based on the premise that the principal conducts the relevant business through any employees, representatives or agents it hires or engages. While principals are under a legal obligation to control and supervise their employees and agents, they also have a direct incentive to have in place

97 See the objectives of regulation in Part 3.

appropriate mechanisms to train, supervise and control their employees and agents effectively. This incentive arises from the fact that it is the principal's reputation in the market which will be adversely affected by any activity (intentional or otherwise) which result in losses to a client.

The Corporations Law approach was adopted following the recommendations of the National Companies and Securities Commission's 1985 Green Report, which recommended moving away from the direct licensing of representatives and agents. The reasons for this recommendation, which are still relevant, include the need to ensure that government resources available for regulating intermediaries are most effectively targeted, and to facilitate market forces and competitive pressures. The removal of direct licensing of representatives was compensated by:

- imposing liability on the principal to compensate any loss suffered by a client as a result of a representative's conduct (see Division 4 of Part 7.3);
- imposing standards of conduct which require full disclosure of an adviser's, and their associates', conflicts of interest (see section 849), and the suitability of recommendations to a client's individual circumstances, investment objectives and particular needs (see section 851); and
- specifying the responsibility of the principal for adequate training and supervision of representatives (see Corporations Regulation 7.3.02(1)).

In light of the need to settle on one regulatory approach for the purpose of developing a single licensing regime, the Government supports the FSI recommendation to licence all principals rather than agents.[98] The FSI recognised that a functional approach to regulation of intermediaries requires consistent regulation of all advice and sales of financial products. The convergence between different financial investments, like life insurance and managed investment products, reinforces the need for a single licensing regime. It is appropriate that the regime be targeted at the legal entity with responsibility for the intermediation process and with the incentives to ensure satisfactory outcomes for investors. Accordingly, it is proposed that the Corporations Law approach of licensing principals will be adopted.

98 *Financial System Inquiry Final Report*, March 1997, p 272.

8.3 WHO WILL NEED A FINANCIAL INTERMEDIARY'S LICENCE?

A person will require a financial intermediary's licence if they propose to conduct a business of:

- providing advice on financial instruments;
- dealing in financial instruments on behalf of other persons;
- holding out that they are willing to enter into either side of a financial instrument as principal (market making) or otherwise provide professional intermediary services including structuring and selling financial instruments;
- arranging for one person to enter a financial instrument transaction with another person; and
- operating managed investment schemes or providing custodial and depository systems.

Principals will be responsible for accrediting their employees or agents based on standards of competence and integrity and will be liable for their conduct and actions.

Persons who will not require a financial intermediary licence will include:

- licensed market operators;
- agents or employees of a financial intermediary (although these persons will require appropriate authorisation from the financial intermediary to provide specified advisory or dealing services);
- persons conducting business on their own accounts and investors who regularly participate in market transactions. This exemption will not apply to participants which structure and sell products to third parties or hold themselves out as professional intermediaries (eg OTC derivative market makers);
- dealings within corporate groups or joint enterprises;
- professional advisers giving incidental advice in the course of a business other than a financial investment business (eg, solicitors and accountants); and
- real estate agents giving negative gearing advice (until the ACFSC undertakes a review of the adequacy of their licensing requirements).

8.4 WHOLESALE FINANCIAL INTERMEDIARIES

Whether financial intermediaries who only deal on behalf of sophisticated or wholesale clients should be licensed has been the subject of some debate. Possibilities for the regulation of wholesale intermediaries include:

- positive licensing — where the intermediary must satisfy established entry requirements before they will be permitted to provide advisory or dealing services; or
- negative licensing — where there are no preliminary entry requirements to be satisfied in order to provide intermediary services. However an intermediary may subsequently be prohibited from providing services if they breach standards of market conduct or otherwise act improperly. This is similar to the current regulation of company directors under the Corporations Law.

The imposition of a positive licensing regime on intermediaries in the wholesale market has been criticised on the grounds that there is no regulatory justification for such a regime which would impose onerous burdens on wholesale intermediaries. Wholesale clients are presumed to be capable of looking after their own interests and will not deal with an intermediary who does not have competence and integrity.

However, there are significant factors in favour of a positive licensing regime:

- the regulation of intermediaries aims to promote market integrity, not just retail investor protection;
- the distinction between wholesale and retail participants is not always clear, such as where retail funds pass through a professional or trust for investment in the wholesale market;
- other major jurisdictions licence intermediaries generally;
- the power to ban a participant under a negative regime cannot be utilised quickly and is less effective against foreign participants; and
- the requirements to provide information to regulators may assist regulators in gaining a clearer picture of activity within the Australian financial markets as a whole.

On balance, a positive licensing regime is preferred in relation to licensing of wholesale intermediaries. However, it is important to ensure that

inappropriate regulatory burdens are not imposed on wholesale-only intermediaries.

8.5 LICENCE CRITERIA

It is proposed that a financial intermediary will be required to have:

- adequate financial resources for the performance of the proposed activities; and
- competence, skills and experience to provide the relevant services.

A financial intermediary will be required to conduct their business honestly, efficiently and fairly.

It is proposed to retain the current arrangements where the regulator may impose conditions on an intermediary's licence to ensure that objectives of market regulation are satisfied on a continuing basis. Alternatively, generic licence conditions which apply to all intermediaries could be set out in regulations. Failure to comply with conditions may result in administrative action including the withdrawal of the licence.

The Government supports the role played by industry in promoting best practice and considers that industry associations should work closely with the regulator to develop detailed guidelines or industry codes. Responsibility for particular aspects of the licensing system could be delegated to industry associations which demonstrate their ability to carry out responsibilities in the public interest.

The broad legislative criteria are intended to apply to a range of financial intermediary services. Currently there is a broad spectrum of intermediary activities including:

- providing information on investment products;
- providing advice in relation to limited products;
- providing comprehensive investment advice; and
- selling, dealing or other brokering services in relation to investment products.

Some examples of how the criteria will apply to certain intermediaries are provided below.

Resources

The level of resources which will satisfy the legislative criteria will vary depending on the nature of the services provided by the financial intermediary. For example, intermediaries which only provide advisory services will not require the same level of resource backing as an intermediary which is dealing as a counterparty to clients.

Competence, Skills and Experience

Competency should be demonstrated at the point of entry to the industry as well as on an ongoing basis. Financial intermediaries should demonstrate organisational competency (computer, supervisory and risk management systems) as well as personal competency requirements for management and staff including authorised advisers and dealers. For example, a licensee should ensure that securities advisers who provide personal recommendations to retail clients have adequate knowledge and understanding of the operation of investment markets, the ability to analyse the investment needs and goals of particular clients, develop investment strategies as well as understand the general regulatory environment including taxation implications.[99]

Risk Management

Intermediaries are increasingly engaging in wholesale market activities, including creating highly leveraged transactions and trading in complex financial instruments. Concerns have been expressed regarding possible contagion or systemic risks in the event of a default by an intermediary.

Risk management systems are designed to assist a participant to identify and measure risk. Adequate systems protect against excessive or unauthorised risk exposure and protect counterparties by reducing the possibility of default. Systems should accurately identify exposure and risk limits and promote the use of internal procedures and controls to ensure compliance with these systems, for example through the separation of trading and settlement functions (front and back office). Capital adequacy requirements also contribute to achieving this objective.

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99 See the ASC Licensing Review Report on investment Advisory Services, '*Good Advice*', and ASC Policy Statements 121 and 122.

The FSI considered that most of the current participants in financial market activities are prudentially regulated by the RBA. Therefore the FSI recommended that there was no need, at the present time, to require financial market intermediaries to be subject to additional prudential regulation.[100] However, the FSI recommended that regulatory agencies monitor the wholesale markets for the emergence of participants who are not prudentially regulated.

The legislative reforms outlined in this paper may lead to the emergence of new participants which are not subject to prudential regulation engaging in financial intermediary activities. In particular, removing the restriction on retail participation in the OTC derivatives markets may result in new firms which specialise in providing tailored hedge contracts in commodities or currency to the retail sector. These activities may result in significant performance obligations or financial commitments by the intermediary. These firms may not necessarily be subject to supervision by APRA or a SRO which operates a market or clearing and settlement facility.

The absence of supervision of these firms and the possible lack of margining and other risk management requirements could potentially result in considerable losses to retail investors who participate in OTC transactions. Although it is proposed that all intermediaries must have compensation mechanisms when dealing with retail investors, it is considered that these firms should be subject to appropriate scrutiny of their risk management systems to help minimise the risk of failure.

It is important that regulation ensures that participants who engage in these activities have appropriate capital resources and risk management systems to provide assurance that they are capable of meeting their obligations in relation to the activity on an ongoing basis.

Therefore financial intermediaries must demonstrate that they have appropriate capital resources and risk management systems to carry out their proposed activities.[101] This requirement will apply to dealers which act as principals for clients and intermediaries which act as counterparty to their clients given the particular risks involved in carrying out these activities. It will not apply to intermediaries which:

- only provide advisory services;

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100 *Financial System Inquiry Final Report*, March 1997, recommendation 18.

101 This requirement is additional to the potential liability of directors who may be in breach of their common law and statutory duties if they fail to ensure that their entity adopts appropriate risk management systems: *Daniels v AWA* (1995) 16 ACSR 607.

- are subject to prudential regulation by the RBA; and
- are subject to satisfactory supervision by a foreign prudential regulator or a licensed market operator or clearing facility. Market operators or clearing houses may impose capital requirements and risk management procedures on participants which access their facilities. These requirements should be taken into account when assessing whether an intermediary has adequate systems to limit risk.[102]

Legislation or the regulator will not prescribe particular risk management systems given that they are constantly developing and vary depending on the complexity and nature of the particular business conducted by an intermediary. Intermediaries will be required to demonstrate that the systems are adequate for the proposed activities and should, where appropriate, be consistent with international best practice.[103]

The adequacy of risk management systems will be assessed as part of the requirement that an intermediary has adequate competence, skills and experience to conduct the proposed activities.

Proposal No. 5 — Financial Intermediaries

A single licensing regime will be introduced for financial markets dealers and advisers.

The criteria to be satisfied to obtain a financial intermediary's licence will be that the intermediary must:

- have adequate financial resources for the performance of the proposed activities; and

Continued

102 These proposals are consistent with the CASAC, *Final Report on the Regulation of On-Exchange and OTC Derivatives Markets,* June 1997, recommendations 21, 22, 26 and 27.

103 For example, see the IOSCO Technical Committee Report *Operational and Financial Risk Management Control Mechanisms for Over-the-Counter Derivatives Activities of Regulated Securities Firms* (July 1994). For further examples, see CASAC *Final Report on the Regulation of On-Exchange and OTC Derivatives Markets,* June 1997, p 130.

- have the competence, skills and experience to provide the relevant services.

Conditions will be imposed on a financial intermediary's licence to ensure that the objectives of market regulation are satisfied on a continuing basis.

PART 9: CONDUCT OF BUSINESS BY FINANCIAL INTERMEDIARIES

9.1 INTRODUCTION

Retail investors are faced with increasingly complex financial products and a wide range of choices to achieve particular investment goals. The growth in the complexity of services and products provided by financial institutions has created an imbalance between intermediaries and retail investors. Generally retail investors do not have adequate knowledge or experience in the operation of investment markets. It is important to ensure that minimum standards apply to the conduct of advisory and dealing services provided to retail investors.

9.2 CONDUCT OF BUSINESS REQUIREMENTS

As noted in Part 5, financial intermediaries are currently required to comply with varying requirements in relation to the conduct of their advisory and dealing services depending on the classification of the particular product on which they provide services. It is proposed that these requirements will be harmonised for all financial intermediaries who provide advice to retail clients.

The following proposed requirements would be expressed as general legislative principles. Detailed procedures which provide guidance on how the principles will be satisfied may be developed by the regulator and industry associations. The more detailed requirements may be imposed on the intermediary through the conditions attached to a licence or through the adoption of various industry codes. However, it will be important to ensure that the development of codes for particular products do not undermine the policy objective of providing consistent regulation of all intermediary services.

Services Guide

Retail investors may find it difficult to ascertain the nature of particular intermediary services and make judgments about the quality of the services provided by the intermediary.[104] Accordingly, it is proposed to impose a requirement for intermediaries who provide services to a retail investor to provide information on:

- the nature of the services provided;
- the methods of charging investors;
- the nature of the relationship between the investor and the intermediary including capacity in which the intermediary will be acting; and
- the rights of investors including complaints resolution and compensation arrangements.[105]

In some instances it may be appropriate for an intermediary to enter into a client agreement with retail investors[106] eg, where an intermediary operates a discretionary trading account on behalf of an investor or is involved in some other type of ongoing relationship with the client.

Risk Disclosure

It is also proposed that intermediaries be required to provide risk disclosure statements to clients.[107] Risks will vary according to nature of product, and in some instances will include risk associated with the product provider. This issue interlinks with the general point of sale disclosure requirements outlined in Part 10.

Industry should work closely with the regulator to develop the detail to be contained in risk disclosure statements, including the appropriate disclosure of generic and specific risks of investment products.[108]

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104 See ASC Licensing Review Report on investment Advisory Services, '*Good Advice*'.

105 Based on ASC Policy Statement 121.

106 CASAC *Final Report on the Regulation of On-Exchange and OTC Derivatives Markets,* June 1997, p 142.

107 CASAC *Final Report on the Regulation of On-Exchange and OTC Derivatives Markets,* June 1997, p 144.

108 Also see the detailed recommendations in relation to risk disclosure for on-exchange and OTC derivatives in CASAC *Final Report on the Regulation of On-Exchange and OTC Derivatives Markets,* June 1997, p 143-151.

Confirmation Documents

A retail client should be given appropriate confirmation documents when they enter into a contract for the sale or purchase of a financial product. Confirmation documentation informs a client of the terms and conditions of the contract and provides an immediate record of the transaction, as well as evidence of the terms of the transaction, which may be useful for any subsequent dispute about contractual obligations.

Protection of Client Assets

The protection of client assets involves the provision of periodic statements listing client assets held by an intermediary, and the separation of client assets from intermediary assets.

Financial dealers and advisers often hold assets on behalf of their clients. Client assets can be used for initial deposits and margining requirements, or may be held as a consequence of settling transactions on behalf of a client.

It is proposed that an intermediary should periodically account to a retail investor regarding any funds or property held by the intermediary on behalf on the client. The intermediary should provide a periodic statement detailing the amount of assets held and any changes to that amount that have occurred. The length of the reporting period will vary according to the nature of activities conducted on behalf of the client. Accounts which may fluctuate rapidly would require relatively frequent accounting intervals.

Client funds and property should be held in a separate account from the intermediary's assets. The precise nature of the separate account (eg segregated account or trust account) will be determined by the nature of the service provided, licence conditions or industry codes and any rules imposed by a market operator or clearing house.

Record Keeping

Proper and separate record keeping facilitates:

- the identification of the respective legal and financial position of intermediaries and clients and may provide protection in the event of insolvency;
- the resolution of disputes; and

- the performance of surveillance and enforcement activities.

Financial market intermediaries should be required to keep records of the orders received and transactions made on behalf of their wholesale and retail clients for seven years.[109]

Own account dealings should be clearly identifiable and separately recorded in a form that permits the reconstruction of transactions to provide a comprehensive audit trail.[110]

Benefits and Conflicts of Interest

The disclosure of benefits received by an intermediary and any conflicts of interest assists clients in assessing the merits of a product recommendation and reduces the opportunity for advisers to act in self interest to the disadvantage of the client. It is proposed that all financial market intermediaries must disclose the details of any benefit, advantage or interest they may receive as a result of making a recommendation about the purchase of a financial product, including fees or other commissions.

Pressure Sales

An intermediary should be prohibited from using 'boiler room' or other undesirable selling methods, inducing or attempting to induce, through unsolicited contact, any retail person to enter into any financial transaction. Licence conditions or codes of conduct may also impose cooling off periods to protect retail clients from pressure selling tactics.

Suitability

An intermediary which provides personal financial product recommendations to a retail client should be subject to a 'know your client' rule which requires the intermediary to have a reasonable basis for making the recommendation. The adviser must:

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109 CASAC *Final Report on the Regulation of On-Exchange and OTC Derivatives Markets,* June 1997, p 176.

110 CASAC *Final Report on the Regulation of On-Exchange and OTC Derivatives Markets,* June 1997, p 177.

- have regard to information in their possession about the client's investment objectives, financial situation and particular needs; and
- make a reasonable investigation of the subject matter of the product being recommended.

The suitability rule does not require an intermediary to provide a personal recommendation or to provide best advice.[111] An intermediary which provides personal recommendations should make appropriate inquiries and provide warnings to a client who declines to disclose relevant information. Warnings should also be provided in relation to general recommendations which notify the investor that the recommendation does not take account of their particular investment needs or goals.[112]

The suitability rule is designed to address the lack of sophistication of retail investors who, irrespective of the level of risk disclosure, may not be able to adequately analyse their investment needs or develop strategies to achieve their investment goals. Retail clients often rely heavily on the advice of financial adviser.

It is emphasised that the suitability requirement is only proposed to apply to personal recommendations about financial instruments.

Complaints and Dispute Resolution

Intermediaries should maintain adequate internal systems to deal with complaints by retail investors.

Various industry based complaints resolution schemes currently exist for investment services complaints including the Australian Banking Industry Ombudsman, the Life Insurance Complaints Service, the Financial Planning Association Complaints Resolution Scheme and the Superannuation Complaints Tribunal. The Government is considering options on how to develop dispute resolution schemes for all retail financial products and services to facilitate the efficient resolution of complaints in relation to investment advisory and dealing services.

Intermediaries which provide services to retail investors should also maintain appropriate fidelity funds or indemnity insurance arrangements.

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111 ASC Policy Statement 122.

112 See ASC Policy Statement 122 and the ASC Licensing Review Report on investment Advisory Services, '*Good Advice*'.

9.3 Scope of Business Conduct Requirements

It would be inappropriate to impose the obligations on intermediaries which only deal with wholesale or professional investors. Sophisticated investors are presumed to be capable of protecting their own interests in their dealings with financial intermediaries. It is not easy to precisely draw a distinction between retail and sophisticated investors. A proposed definition is provided at Appendix D which is based on ASC Policy Statement 121 and CASAC recommendation 1 with some minor modifications. A measure of flexibility will be provided by permitting investors to nominate which category they fall within, either by permitting retail investors to opt up to being classified as wholesale or vice versa.

Proposal No. 6 — Conduct of Financial Intermediary's Business

Statutory obligations will be imposed on intermediaries in relation to their dealings with retail investors including requirements relating to:

- risk disclosure;
- confirmation documentation and periodic statements;
- accounts and record keeping;
- benefits disclosure;
- pressure sales;
- the suitability of personal product recommendations; and
- complaints and dispute resolution.

PART 10: DISCLOSURE

10.1 INTRODUCTION

Disclosure regulation aims to enhance market integrity and transparency by facilitating the adequate dissemination of information to assist:

- the price formation process — prices should reflect all available information; and
- investors to make informed investment decisions. Disclosure requirements promote the more efficient allocation of resources by assisting investors to choose investment products which will achieve their investment strategies and goals. Disclosure regulation addresses information imbalances by imposing disclosure requirements on issuers or promoters of financial products. This is generally a more practicable and cost-effective approach than requiring numerous unconnected potential investors to undertake research and due diligence inquiries in relation to an investment product.

10.2 FSI AND CLERP FUNDRAISING PROPOSALS

As discussed in Part 5, the current disclosure obligations vary according to the nature of the particular investment product.

The FSI noted that disclosure regulation is at the core of any regulatory scheme to protect consumers as it assists them to make informed investment decisions. However, it is important to ensure effective disclosure, not merely the production of information.[113]

To overcome the problems faced by investors (as well as other market participants) caused by information disclosure rules with varying status, application, degree of prescription and penalties for breach, the FSI recommended that there should be a consistent and comparable disclosure

113 *Financial System Inquiry Final Report,* March 1997, p 261.

regime for all retail financial products including securities, managed investments, superannuation and insurance products and deposit accounts.[114]

The FSI generally endorsed the general disclosure approach of the prospectus requirement of section 1022 of the Corporations Law and, to improve the cost effectiveness of the prospectus provisions, and comparability across financial instruments, recommended the introduction of mandatory profile statements for more effective disclosure.[115] These statements would set out specified information (such as a description of the characteristics of the product, a statement of the risks involved, and of relevant fees, commissions and charges) in a format developed by the ACFSC in consultation with industry groups.

The CLERP paper on Fundraising deals with the FSI's recommendation relating to profile statements. The paper endorses the continued use of the general disclosure test embodied in section 1022 of the Corporations Law. The paper also proposes that, rather than require the preparation of profile statements (since such a requirement would impose additional costs on all issuers), the regulator should be given the power to authorise industry specific profile statements which contain key information determined by the regulator in consultation with industry. Sector-specific statements would assist investors to make comparisons between specific products.[116]

Government Response

On 2 September 1997, the Treasurer announced in the Government response to the FSI recommendations, that the disclosure requirements for retail financial products will be reviewed to ensure that investors are provided with information which enables comparison between products. The Treasurer emphasised that information must be comprehensible to assist informed decision making and that the requirements should be consistent for similar products regardless of which institution offers them.

The proposals made by the FSI and in the CLERP Fundraising Paper have been taken into account in formulating the following proposals for reform.

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114 *Financial System Inquiry Final Report,* March 1997, recommendation 8.
115 *Financial System Inquiry Final Report,* March 1997, p 265, and recommendation 9.
116 Corporate Law Economic Reform Program, Proposals for Reform: Paper No. 2, *Fundraising*, pp 13-22.

10.3 PROPOSALS FOR REFORM

It is highly desirable that a consistent disclosure regime be developed for all financial instruments. Although the FSI recommendations related to retail financial products, it would be difficult to distinguish between retail and sophisticated products. It is generally acknowledged that one standard disclosure obligation should apply to all products although it may be difficult to formulate the standard given the different characteristics of individual products.

There is a wide diversity of products available in the finance industry spanning the full spectrum of risk/return preferences of consumers. Product diversity poses unique challenges for disclosure regulation, in particular, how to ensure that prospective investors have sufficient information to make informed and meaningful comparisons between products, without imposing undue compliance costs or overly prescriptive and inflexible regulation on the issuers and the market.

It is vital that investors be supplied with clear and comprehensible disclosure in a form which enables them to assess and compare different investments. This is particularly important in an era likely to:

- herald an increase in direct marketing of investment products;
- lead to more product blurring; and
- lead to greater involvement by retail investors in investment markets.

It is proposed that a general disclosure standard be developed for all financial instruments. While recognising the complexities involved in developing the proposal, a single standard should be implemented as far as possible in order to achieve the policy objectives of consistent disclosure to assist investors to make informed decisions. Extensive consultation with industry will be undertaken in developing legislation and other regulatory mechanisms, which implement the proposal in order to achieve the desired outcome to the greatest extent possible.

Formulation of General Standard of Disclosure

The proposed formulation of a general standard is one option which may result in more consistent and comparable disclosure for similar financial instruments.

The disclosure requirement for prospectuses contained in section 1022 of the Corporations Law is generally supported as it places the onus on 'issuers' and promoters of products to disclose all information which would be reasonably required to make an informed assessment of the financial instrument. However, in order to provide sufficient comparability between similar investment products, it is likely that issuers and promoters of certain financial products will require a higher level of guidance than that which is provided by a general disclosure requirement based on the prospectus provisions.

Therefore it is proposed that the formulation of a single disclosure requirement will be based on the general disclosure test as well as providing a list of items which must specifically be addressed in the disclosure document.

The proposed disclosure obligation will require the disclosure of clear and comprehensible information which promotes comparability between financial instruments and promotes informed investment decisions. The document must contain all information which an investor would reasonably require to make an informed decision, including information about:

- the characteristics of the product and the rights attaching to the financial instrument;
- the risks associated with the investment product;
- all commissions, fees and charges; and
- the nature of the disclosure document — the document should enable investors to understand that it is a selling document, and does not involve a recommendation that the financial product is suitable for the investor's particular needs or objectives.

It would be difficult for the legislation to prescribe in detail the information needs of investors in relation to particular financial instruments, particularly in an era of rapid product innovation and product blurring and the varying features or risks of particular financial instruments. The proposed formulation of the disclosure standard therefore relies on the requirement to disclose all information required to assist an investor to make an informed assessment of the product. It may be the case that disclosure of relevant information under the specific categories may satisfy the general disclosure requirement for simple financial instruments. However, the retention of a general requirement will ensure that all information is disclosed in the event that some relevant matters do not fall within the specific categories.

The relationship between the general disclosure obligation and the specific issues to be addressed in a disclosure document will need to be carefully considered to ensure that the desired outcomes are achieved. It is not the

intention to impose unnecessary or unduly burdensome requirements on issuers and promoters. For example, it is not intended that a prospectus type document be provided to a customer who is opening a deposit account.

The application of this test will vary depending on the particular nature of the financial product. Simple, capital guaranteed products will not require the same volume of disclosure as more complex, market-linked products. For example, under the proposed disclosure standard, little information would be required to satisfy the obligation to disclose information regarding the risks involved in bank deposits and RSAs. Investment-linked products like some regular premium superannuation products would usually require the disclosure of more information regarding investment risks. Nevertheless, the proposed regulatory framework should result in more consistent and comparable disclosure which permits investors to make more informed investment decisions.

Comments are invited on whether the general standard should require disclosure of information which investors, and their professional advisers, would reasonably require, and reasonably expect to find in the disclosure document. This is the basis of the current prospectus requirement and the words ‘expect to find’ are intended to limit the disclosure obligation.

Who Will Be Required to Provide the Information

The aim of the proposed single disclosure requirement is to increase comparability between different financial instruments at the ‘point of sale’. Therefore the document must be provided to the potential investor/client before they acquire the financial instrument.

It is easy to impose the disclosure obligation on entities which ‘issue’ a product, such as life companies, banks and warrant issuers. It becomes difficult when financial instruments are distributed by financial intermediaries (agents and dealers) or where the product is not issued by a particular entity (eg exchange traded derivatives). In these instances, the document should be provided by the person who has contact with the client, eg the dealer or intermediary, although it may be prepared, in some instances by the ‘issuer’ of the product. The document may also be provided by a market operator similar to the current explanatory booklets issued by the ASX in relation to various products.

However, the obligation on intermediaries and market operators to provide disclosure documents will require careful analysis to ensure that inappropriate burdens are not placed on market participants. For example, an intermediary

should not be required to disclose the risks of an investment to a client every time they buy or sell financial instruments on a licensed market. The point of sale disclosure requirement may be linked with the statutory obligation imposed on financial dealers and advisers to disclose the risks of a financial instruments to clients (see Part 9). Detailed procedures may be developed in regulations or the rules of market operators which ensure that an intermediary provides a client with generic disclosure documents at the outset of the relationship and provides more specific disclosure statements as required.

Obviously, liability will be a crucial issue which must be considered in developing the proposed disclosure regime. The due diligence defences in the Corporations Law, subject to the proposed reforms outlined in the CLERP paper on Fundraising, should apply to the general disclosure requirement for all financial instruments. Similarly, intermediaries which pass on disclosure documents prepared by product 'issuers' should not be liable for false or misleading statements in the document provided that they have a reasonable belief that the document is not false or misleading.

Interaction with Prospectus Regime for Securities

The current disclosure requirements under the prospectus regime for securities (shares, debentures, managed investments) will be retained subject to the proposed reforms in the CLERP paper on Fundraising. It will not be necessary for issuers of these financial instruments to also comply with the proposed uniform disclosure requirements outlined above.

The proposed development of profile statements under the Corporations Law will assist in providing comparability between securities and other investment products.

Advantages of Proposed Regime

Using a more general approach to disclosure requirements provides greater flexibility for the market and its users. A general approach avoids the continued reliance on artificial legal distinctions which are inherently inflexible and do not promote comparability between financial instruments. The proposed general formulation also addresses a desired outcome — namely, providing investors with the information necessary for them to make informed investment decisions — rather than specifying a disclosure process which may not necessarily satisfy investors' information needs.

By focusing the attention of product issuers and promoters on the outcome to be achieved, a general approach will be applicable to a wide range of circumstances and financial instruments, and will hence be responsive to changes in investors' needs, market expectations, and innovations in market practices and products. The general approach thus affords more flexible and effective regulation by ensuring that issuers and promoters take responsibility for ensuring that appropriate information is provided on their products.

The regulator will be required to work closely with industry to implement the proposed general standard disclosure requirement to the greatest extent possible, including the possible development of profile statements for particular financial instruments. This will assist in providing certainty to issuers and promoters of financial products. However, it will be important to ensure that the objectives of comparability and consistent regulation are not undermined by the development of varying requirements for particular industries.

The Government invites comments on the proposed development of a standard disclosure requirement and how the proposal may best be implemented or developed to achieve better disclosure outcomes for investors and market participants.

Proposal No. 7 — Disclosure

It is highly desirable that a consistent and comparable disclosure regime for all financial instruments be developed. The Government seeks comments on the proposed formulation of the disclosure standard including how a regime may be developed to assist investors to make comparisons across all financial instruments.

All financial instruments, other than securities which are subject to the prospectus provisions, will be subject to a requirement to disclose all relevant information to permit investors to make informed investment decisions. The disclosure document must address specific issues in order to increase comparability across similar investment products. Promoters or issuers of financial products will be required to disclose to investors the fundamental terms and obligations attaching to a financial product as well as the risks involved with the product and all fees, commissions and charges.

The fundraising provisions will apply to specified financial instruments (shares, debentures, managed investments). The development of profile statements under the Corporations Law will assist investors to compare securities and other financial instruments.

PART 11: CONDUCT IN RELATION TO FINANCIAL INSTRUMENTS

11.1 INTRODUCTION

Market misconduct provisions protect the integrity of the marketplace. Intermediary misconduct provisions operate to protect individual participants in the financial service industry. Market operators have a strong interest in ensuring the integrity of the market which it has been licensed to conduct. The obligations to supervise the market (Part 6) include monitoring and reporting abusive market practices.

11.2 CURRENT REGULATION

The Corporations Law regulates a number of forms of market misconduct in both securities and futures markets:[117]

- insider trading;
- a general prohibition on misleading or deceptive conduct; and
- specific offences relating to:
  - market manipulation;
  - false trading;
  - market rigging transactions;
  - dissemination of information about illegal transactions; and

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117 *Securities Markets* — Division 2 of Part 7.11 of the Corporations Law contains the provisions for dealing with market misconduct. In particular section 995, the general catch all provision, prohibits misleading or deceptive conduct in relation to securities. In addition, other specific conduct is prohibited in the remaining provisions such as, stock market manipulation, false trading and market rigging transactions and the dissemination of information about illegal transactions. Division 2A contains detailed rules which prohibit insider trading.
Futures Markets — Part 8.7 of the Corporations Law contains the provisions dealing with futures market misconduct. The provisions cover offences such as, insider dealing, market manipulation, false trading and market rigging and the dissemination of information about illegal transactions.

- other fraudulent offences.[118]

The Corporations Law also provides administrative sanctions for the breach of intermediary licensing conditions for both securities and futures intermediaries.[119] The ASC has the power to ban, deregister or suspend an intermediary where an intermediary:

- becomes insolvent;
- is convicted of a serious fraud;
- contravenes the Corporations Law;
- contravenes a condition of their licence;
- is not of good fame and character; or
- has not conducted its business honestly, efficiently and fairly.

11.3 Proposals for Reform

Market Misconduct

The market misconduct provisions covering the conduct of securities and futures markets are somewhat similar and are intended to achieve the same regulatory objectives. That is, they are designed to maintain investor confidence in the market and to protect the integrity of the market.

The securities insider trading provisions were updated in 1991 as part of a general securities reform process. However, the futures insider trading provisions were not amended. It is proposed that the provisions be harmonised for financial instrument markets. It is proposed to base the provisions on the securities provisions.

CASAC in its *Regulation of On-Exchange and OTC Derivatives Markets Report* considers market misconduct from a derivatives perspective. CASAC recommends that the principles currently applying to futures trading should apply to all on-exchange derivatives transactions, subject to some reform.[120]

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118 For example sections 999,1000, 1261, 1262 and 1264.
119 Corporations Law, Division 5 of Part 7.3 (securities) and Division 5 of Part 8.3 (futures).
120 CASAC *Final Report on the Regulation of On-Exchange and OTC Derivatives Markets,* June 1997, p 193.

The insider trading provisions should extend to all equity derivatives, including index options and index warrants, but not to derivatives based on commodities. A prohibition on the insider trading of derivatives over equities supports the prohibition on the insider trading of the underlying equities. However, to extend the insider trading provisions to derivatives over commodities would prohibit a person buying a derivative over the commodity, although the person could still lawfully buy or sell the commodity itself.[121]

The CASAC report considers other on-exchange offences and recommends extending them to on-exchange derivatives markets.[122]

Only some OTC derivatives market transactions are subject to market manipulation and other improper conduct offence provisions in the Corporations Law. CASAC considers that insider trading and market manipulation offences, similar to those proposed for an on exchange derivatives markets, should also apply to the OTC derivatives market.[123] These provisions should ensure that accepted OTC practices, such as price and liquidity support structures and issuer-buy back of fixed interest securities, are not affected.

Enforcement of Licence Conditions

Currently, not all financial licensing regimes have the administrative enforcement powers provided to the ASC by the Corporations Law. As part of the harmonisation of financial instrument regulation, and in the interests of investor confidence and market integrity, the ACFSC should have the power to impose administrative sanctions as a means of enforcing the Law in relation to all financial instruments. As a result, the proposed single licensing regime will be mirrored by a single enforcement regime.

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121 CASAC *Final Report on the Regulation of On-Exchange and OTC Derivatives Markets,* June 1997, p 195.

122 CASAC *Final Report on the Regulation of On-Exchange and OTC Derivatives Markets,* June 1997, pages 195-198.

123 CASAC *Final Report on the Regulation of On-Exchange and OTC Derivatives Markets,* June 1997, p 197.

Proposal No. 8 — Market Misconduct

The market misconduct provisions of the Corporations Law, which include insider trading and market manipulation will be harmonised for all markets where financial instruments are regularly traded by multiple buyers and sellers.

Rules relating to misconduct by financial advisers and dealers, including breaches of licence conditions, will be harmonised and enforced by the ACFSC.

PART 12: REGULATORY RESPONSIBILITY

12.1 NEW REGULATORY FRAMEWORK

On 2 September 1997, the Treasurer announced that a new framework for the regulation of the financial system based on the FSI recommendations will be established. The new framework will be based around the RBA, APRA and the ACFSC.

12.2 AUSTRALIAN CORPORATIONS AND FINANCIAL SERVICES COMMISSION

The Australian Corporations and Financial Services Commission (ACFSC), will be based on the existing Australian Securities Commission (ASC). In addition, relevant responsibilities will be transferred to the new body from the Insurance and Superannuation Commission (ISC), the Australian Competition and Consumer Commission (ACCC), the Australian Payments System Council (APSC), and the Australian Financial Institutions Commission (AFIC) and associated State Supervisory Authorities (SSAs). This will require the agreement of State and Territory Governments.

It is proposed that the ACFSC will be responsible for:

- corporate regulation, and securities and futures markets (currently performed by the ASC);
- market integrity and consumer protection functions in connection with banks, finance companies, merchant banks, building societies, credit unions, friendly societies, superannuation interests, retirement savings accounts, and general and life insurance products (but not including State and Territory consumer credit functions);
- consumer protection functions for the finance sector (currently performed by the ACCC and the APSC); and
- oversight of industry initiatives for consumer protection in the areas of new technology in the finance sector and ensuring they develop in a coordinated way.

In recognition of the importance of the credibility and security of the financial system to the wider economy, the ACFSC would be given a full range of enforcement options, access to adequate resources for enforcement functions and a mandate to use them where appropriate.

A single agency which is responsible for the oversight of market conduct, the integrity of markets, consumer protection and corporations, should result in an agency:

- that is better focused on the requirements of consumer protection;
- that is more responsive to changes in financial products, the modes of financial service delivery and the nature of participants in the financial services industry; and
- which can provide a more consistent approach to the conduct and disclosure requirements of similar investment vehicles.

There would need to be either a new Act to establish the ACFSC and provide for its powers and functions, and/or substantial changes in the existing *Australian Securities Commission Act 1989*, the *Corporations Act 1989* and the Corporations Law (including changes to the complementary State and Territory legislation). A number of other Acts would also need to be amended or repealed.

12.3 Regulation of Financial Markets and Investment Products

The substantive law reform proposals outlined in this paper and the transfer of responsibilities to a single regulatory agency will have a major impact on the regulation of financial markets and investment products. The harmonised regulatory requirements and the streamlining of regulatory responsibility will confer benefits, in the form of greater efficiency and a reduction in compliance costs, on market participants and investors.

The Government is seeking comments on the appropriate mechanism for responsibility for the new regulatory framework for financial markets and investment products.

One option would be to retain the current division of responsibility under the Corporations Law for regulating markets and financial intermediaries. The Treasurer would be responsible for licensing markets, clearing and settlement facilities and considering amendments to market rules. The ACFSC would

administer the licensing regime for financial advisers and dealers. It is proposed that the arrangements contained in the Corporations Law Amendment (ASX) Bill be retained to enhance the public accountability of market operators, through clarifying the roles of SROs and the Treasurer.

This approach may ensure that there are appropriate checks and balances on the exercise of powers in relation to markets and intermediaries. It would also ensure that the wider economic objectives are taken into account in the decision making process, for example, competitive issues relating to new market entrants. Retaining the existing arrangements may also facilitate the implementation of the new regulatory regime.

An alternative approach would be to provide the ACFSC with responsibility for the day to day administration of the new regulatory regime. The ACFSC would be responsible for administering all aspects of the new regulatory regime including licensing markets, clearing and settlement facilities and financial intermediaries.

However, given the economic significance of financial markets and investment products, it is proposed that the Treasurer would oversee the performance of the ACFSC through the following mechanisms:

- the Treasurer may give directions to the ACFSC[124] about the priorities and policies it must pursue in carrying out its functions;
- the ACFSC must report regularly to the Treasurer on the exercise of its discretions, including the number of applications for licences and the numbers granted or refused;
- the ACFSC must immediately notify the Treasurer of any matters which would have significant ramifications for the regulation of the financial system; and
- the Treasurer may ask the ACFSC to provide a special report on the performance of its functions and the exercise of its powers.

If the Treasurer is of the opinion that a market is not complying with its ongoing obligations, the Treasurer may publish a notice in the Gazette directing the market to do specified things that the Treasurer believes will promote compliance by the market with those requirements.

In addition to the obligations outlined above, the ACFSC would be required to develop internal accounting systems and reporting arrangements to identify

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124 Based on the Treasurer's current directions powers under sections 12 and 14 of the *Australian Securities Commission Act 1989.*

effectiveness and efficiency in carrying out its regulatory responsibilities and report annually to Parliament.[125]

Accountability of the ACFSC would also be provided through:

- an annual report from the ACFSC to the Treasurer.[126] Each market operator must prepare an annual report for the ACFSC regarding compliance with ongoing statutory requirements. The Treasurer may also require a market operator to prepare a special report on the extent to which the market is complying with these ongoing requirements. A compilation of the market reports, both annual and special, must be provided annually to the Treasurer;
- subjecting decisions to a right of review;
- clarifying the charter of the regulator — eg, the ASC must facilitate competition and financial innovation, and the development of new markets while maintaining market integrity and investor confidence; and
- utilising the Financial Sector Advisory Council[127] to gain feedback from the business community on the operation of the new regime.

This approach would be consistent with the overall regulatory framework for the financial system, based on the FSI recommendations which have been accepted by the Government in relation to APRA and the RBA. Given the blurring of boundaries between some market services and broker activities, the administration of the new regime by one entity may ensure more comparable regulation of similar financial market activity. It may also remove any possible uncertainty which may result in separating responsibility for various elements of the new regulatory regime.

12.4 Delegating to Industry Bodies

As recommended by the FSI, the regulator will have the power to use a combination of regulatory approaches including the ability to delegate responsibility to industry bodies.[128] For example, the regulator will be able to delegate responsibility for competency training and testing to industry bodies and may be able to adopt detailed industry codes which prescribe appropriate conduct and disclosure requirements.

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125 *Financial System Inquiry Final Report,* March 1997, recommendation 109.

126 These proposals are based on proposed sections 769B to 769D of the *Corporations Law Amendment (ASX) Bill 1997.*

127 *Financial System Inquiry Final Report,* March 1997, recommendation 110.

128 *Financial System Inquiry Final Report,* March 1997, recommendation 7.

12.5 INFORMATION SHARING BETWEEN REGULATORS AND INDUSTRY BODIES

In order to maintain seamless regulatory cover over the financial services industry, the three proposed regulatory bodies must be able to exchange information, subject to the existence of adequate data protection measures.[129] Information to be shared would include details of overall activity by participants in the finance industry, especially where the participant is subject to regulation by more than one regulatory body.

From a regulatory point of view, there are two other vital information pathways that should be free from any impediment:

- there should be adequate disclosure of information between financial industry participants and financial market operators; and
- there should be a free flow of information between financial market operators and the appropriate regulatory bodies.[130]

These sources of information are extremely important for a number of reasons:

- the free flow of information will maximise the efficacy of the financial markets;
- market operators will be able to assess members' activities and exposures to the market; and
- regulatory bodies will be able to better monitor the markets for potential weakness in terms of both prudential oversight and market misconduct.

As a result, any impediments to information sharing between market operators and regulatory bodies, and between regulatory bodies themselves, should be minimised.

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129 *Financial System Inquiry Final Report,* March 1997, recommendation 111.
130 *Financial System Inquiry Final Report,* March 1997, recommendation 57.

Proposal No. 9 — Regulatory Responsibility

The proposed implementation of the reforms to the regulation of financial markets and investment products will result in a new approach to the regulation of financial market participants. The Government seeks comments on the appropriate mechanisms for responsibility for the new regulatory regime.

One option would be to retain the current division of responsibility for regulating markets and intermediaries as adopted by the Corporations Law. The Treasurer would be responsible for licensing markets, clearing and settlement facilities and considering amendments to market rules. The Australian Corporations and Financial Services Commission (ACFSC) would administer the licensing regime for financial advisers and dealers. If the Treasurer is of the opinion that a market is not complying with its ongoing obligations, the Treasurer may publish a notice in the Gazette directing the market to do specified things that the Treasurer believes will promote compliance by the market with those requirements.

An alternative approach would be to provide the ACFSC with responsibility for the day to day administration of the new regulatory regime. The ACFSC would be responsible for all aspects of the single licensing regime, including licensing markets, clearing and settlement facilities and financial advisers and dealers. The ACFSC would oversee the product disclosure requirements for all financial instruments and have broad enforcement powers relating to financial markets and investment products.

Given the economic significance of markets and investment products, the Treasurer would oversee the performance of the ACFSC through the following mechanisms:

- the Treasurer may give directions to the ACFSC about the priorities and policies it must pursue in carrying out its functions;
- the ACFSC must report annually to the Treasurer on the exercise of its discretion, including the number of applications for licences and the numbers granted and refused;

Continued

- the ACFSC must immediately notify the Treasurer of any matters which would have significant ramifications for the regulation of the financial system; and

- the Treasurer may ask the ACFSC to provide a special report on the performance of its functions and the exercise of its powers in relation to financial markets.

If the Treasurer is of the opinion that a market is not complying with its ongoing obligations, the Treasurer may publish a notice in the Gazette directing the market to do specified things that the Treasurer believes will promote compliance by the market with those requirements.

Accountability of the ACFSC will also be provided through:

- subjecting decisions to a right of review;
- clarifying the charter of the regulator — eg, the ACFSC must facilitate competition and financial innovation, and the development of new markets while maintaining market integrity and investor confidence; and
- utilising the Financial Sector Advisory Council to gain feedback from the business community on the operation of the new regime.

APPENDIX A: BUSINESS REGULATION ADVISORY GROUP

Mrs Catherine Walter	(Chairman) Australian Institute of Company Directors
Mr Peter Barnett	Business Council of Australia
Mr Leigh Hall	Australian Investment Managers' Association
Mr Rohan Jeffs	Australian Chamber of Commerce and Industry
Mr Jeffrey Lucy	Accounting bodies
Mr John Murray	Small Business Coalition
Mr Robert Nottle	Australian Stock Exchange
Mr Malcolm Starr	Sydney Futures Exchange
Mr Les Taylor	Australian Corporate Lawyers Association

APPENDIX B: OVERSEAS APPROACH

The regulation of financial instruments, and in particular securities and futures, in the United States of America and the United Kingdom is considered very briefly.

United States of America

The regulation of financial instruments in the United States is achieved on an instrument by instrument basis.

Life and General Insurance

The overall level of insurance regulation is at the more liberal end of the scale. However, despite embracing the theory of unfettered contestable markets, US governments subject the insurance industry to a substantial level of supervision and oversight.

Oversight of the insurance industry and insurance products occurs at the state government level. A statute in each state establishes a department responsible for the supervision of insurance companies. While the detail varies between states, the principal objectives include measures designed to promote solvency, propriety of premium rates, fair dealing with policyholders, and uniform financial reporting. In the majority of states conducting an insurance business is prohibited without an authorisation from the state insurance department. Any authorisation requirements, such as minimum capitalisation or dividend restrictions, vary between states, and often depend on both the type of insurance company and type of insurance business proposed.

Matters generally addressed by state legislation include:

- the formation and licensing of various types of insurers for the various classes of insurance and reinsurance;
- the licensing of agents and brokers;
- the filing and sometimes approval of property and liability insurance rates;
- the filing and approval of policy forms;
- unauthorised insurers and unfair trading practices;

- financial requirements for insurers;
- periodic reporting and insurer examination requirements;
- complaints handling; and
- guarantee funds.

The National Association of Insurance Commissioners coordinates regulatory matters between the states. While it recommends model insurance regulation, it has no powers of enforcement. Moreover, given the employment, tax and licensing fee revenue implications, each state tailors its regulations in its own interests.

Insurance product distribution varies; some insurance companies use a direct method through tied-agent networks. Most, however, accept business through independent agents and brokers who sell the policies of many different companies.

Securities and Futures

The oversight of US securities and futures regulation is divided between two federal regulatory bodies: the Securities and Exchange Commission (SEC) oversights securities regulation, while the Commodity and Futures Trading Commission (CFTC) oversights futures regulation. The two Commissions in turn authorise and oversee the many exchanges and associations that exist as SROs in relation to each financial instrument.

The CFTC distinguishes between OTC and on-exchange trading: OTC trading in futures is generally prohibited, except for forwards or where the CFTC grants an exemption. Options regulated by the SEC, on the other hand, may be traded both OTC and on-exchange.

The rules governing on-exchange trading of both securities and futures do not generally distinguish between sophisticated and non-sophisticated investors. Retail participation in the OTC market is hindered only by the general futures prohibition. More generally, however, both Commissions may exempt sophisticated parties from the regulations.

Both the SEC and CFTC licence persons as intermediaries. Licensing applies to futures commission merchants, introducing brokers, their associates, floor brokers and floor traders, and to securities brokers and dealers. Intermediary obligations under both Commissions include requirements pertaining to minimum finances, record keeping, client fund segregation and reporting internal control inadequacies to the relevant Commission. Much of the supervision of intermediaries is left to the SROs.

The legislation, which is regulated by the CFTC and SEC, requires intermediaries to disclose risks. Different risk disclosure statements are required depending on the product that is being traded and on the person providing the service. For example, a different type of disclosure statement is needed from an introducing broker dealing in futures than required by a securities dealer. The different levels of disclosure required emphasises the risks that are associated within the different markets and products. In contrast, however, prospectus type disclosure is required only for a primary issues of securities.

While neither Commission directly imposes suitability requirements on financial product advisers, many SROs, have developed ‘know your client’ rules.

Recent debate in the US has focused on whether professional markets should be exempt from regulatory oversight as well as how the regulatory structure should accommodate alternative trading systems.

United Kingdom

The UK system of financial regulation is largely self-regulatory. The *Financial Services Act 1986* provides a multi-tiered system of regulation under which the Department of Trade and Industry has delegated many specific regulatory powers to the Securities Investment Board (SIB). The SIB, in turn, has authorised a number of SROs that make and enforce rules concerning their respective members’ activities in the financial services industry.

The primary purpose of the Financial Services Act is to provide comprehensive regulation of the financial services sector as it affects investors. It defines investment broadly and includes securities, futures, derivatives and life policies made for investment purposes. The Act also recognises a regulatory distinction between on-exchange and OTC markets and wholesale and retail participants.

Investment businesses need authorisation from a SRO to function. The SIB recognises SROs and professional bodies if they meet certain criteria which ensure that they are credible regulatory agencies with adequate powers over investment businesses. The Act requires the SIB to establish a register of authorised persons.

However, this regulatory system is currently undergoing an extensive reform process, which aims to establish a single financial regulator called the Financial Services Authority (FSA). The FSA will initially have the

responsibility for supervising banks, listed money market institutions and related clearing houses. Responsibility will eventually extend the authorisation of members of professional bodies to carry on investment business.

The FSA will be based on the SIB, but will have a much wider scope of regulatory authority. It is envisaged that the FSA will combine the regulatory and registration functions of nine current bodies:

Present Regulatory Organisation	**Area of regulation**
Building Societies Commission	Building societies
Friendly Societies Commission	Friendly societies
Insurance Directorate of the Department of Trade and Industry	Insurance
Investment Management Regulatory Organisation	Investment management
Personal Investment Authority	Retail investment business
Registry of Friendly Societies	Credit unions' supervision (and the registration and public records of building societies, friendly societies, industrial and provident societies and other mutual societies)
Securities and Futures Authority	Securities and derivatives business
Securities and Investments Board	Investment business (including the responsibility for supervising exchanges and clearing houses)
Supervision and Surveillance Division of the Bank of England	Banking supervision (including the wholesale money market regimes)

The high-level regulatory aims of the FSA will include:

- setting, promoting, monitoring and enforcing high standards of integrity, financial soundness, fair dealing and competence for market participants;

- aiming to ensure that consumers receive clear and adequate information about services, products and risks;
- aiming to ensure that while consumers are responsible for their own decisions, they are not exposed to risks they should not be reasonably expected to assume;
- promoting fairness, transparency, and orderly conduct in financial markets, while looking in the first instance to the markets and market participants to set and enforce high standards in this area;
- taking action where standards are inadequate or ineffectively enforced;
- setting, promoting, monitoring and enforcing high standards of financial soundness and probity for financial services businesses, in order to contribute to the soundness of the financial system as a whole and to promote consumers' and financial institutions' confidence in its strength and integrity; and
- aiming to ensure, along with the Bank of England, that the failure of individual institutions does not undermine the overall stability and soundness of the financial system.

The FSA proposes to adopt a flexible and differentiated approach based on risk, in the setting of standards and in industry supervision. The levels will change depending on the business activities concerned, the extent of risk within particular firms and markets, the quality of firms' management controls and the relative sophistication of the consumers involved. An appropriate distinction will therefore be made between retail and wholesale business. The FSA also proposes to adopt a consistent and co-ordinated approach to the authorisation of firms and individuals across the range of business it will regulate.

APPENDIX C: DESCRIPTION OF FINANCIAL INSTRUMENTS

1. A Financial Instrument would include:

Shares

Shares in the share capital of a body corporate, including stock.

Debentures

Documents issued by a body corporate that evidences or acknowledges indebtedness of the body in respect of money that is or may be deposited with or lent to the body.

Government Securities

Debentures, stocks or bonds issued or proposed to be issued by a government.

Interests in a Managed Investment Scheme

Interests which are rights to benefits produced by a managed investment scheme (whether the rights are actual, prospective or contingent and whether or not it is enforceable). A managed investment scheme has the following features:

- people contribute money to acquire rights (or interests) to benefits produced by the scheme;
- the contributions are pooled or used in a common enterprise to produce benefits for the people who hold interests in the scheme; and
- the interest holders do not have day-to-day control over the operation of the scheme.

Derivatives

A derivative includes an agreement:

- the value of which is ultimately derived from or varies according to, the value of one or more assets, rates, indices or other underlying (***derived value element***); and
- whereby one or both parties, at some future time, may have to provide cash or other consideration (excluding any initial or periodic consideration that is fixed at the time the agreement is entered into) to the counterparty or a substitute counterparty (such as the clearing house), that consideration ultimately being determined in whole or part by reference to the derived value element (***liability element***).

but should not include:

- agreements under which physical delivery of a commodity other than a currency is mandatory;
- agreements where the consideration can be varied only by reference to an inflation index (such as the Consumer Price Index);
- at-call or term deposits with banks or other financial institutions;
- all insurance contracts regulated by the ISC; and
- chattel and real property mortgages.

Contracts for Insurance

Contracts of insurance involving the undertaking of liability, by way of insurance, in respect of any loss or damage, including the liability to pay damages or compensation, contingent upon the happening of a specified event.

Superannuation Interest

Superannuation interests are beneficial interests in a superannuation entity such as a regulated superannuation fund, an approved deposit fund, or a pooled superannuation trust.

Life Insurance Policies

Life policies include:

- a contract of insurance that provides for the payment of money on the death of a person or on the happening of a contingency dependent on the termination or continuance of human life;
- a contract of insurance that is subject to the payment of premiums for a term dependent on the termination or continuance of human life;
- a contract of insurance that provides for the payment of an annuity for a term dependent on the continuance of human life;
- a contract that provides for the payment of an annuity for a term not dependent on the continuance of human life but exceeding the term prescribed by the regulations for the purposes of this paragraph;
- a continuous disability policy;
- a contract (whether or not it is a contract of insurance) that constitutes an investment account contract; and
- a contract (whether or not it is a contract of insurance) that constitutes an investment-linked contract.

but should not include:

- a contract that provides for the payment of money on the death of a person is not a life policy if:
  - (a) by the terms of the contract, the duration of the contract is to be not more than one year; and
  - (b) payment is only to be made in the event of:
    - (i) death by accident; or
    - (ii) death resulting from a specified sickness.

Foreign Exchange Contracts

The buying and selling of foreign currency.

APPENDIX D: DESCRIPTION OF RETAIL INVESTOR

1. With respect to the statutory obligations of advisers, a retail client is a person who is not:

   (a) a holder of a dealers or an investment advisers licence or an exempt dealer or investment adviser (as defined in s68 of the Corporations Law). However, a dealer, investment adviser, exempt dealer or exempt investment adviser may ask to be treated as a retail investor;

   (b) a body corporate registered under the *Life Insurance Act 1995*;

   (c) a bank as defined in s 5 of the *Banking Act 1959* or a bank constituted by or under a law of a State or Territory;

   (d) a trustee of a superannuation fund, an approved deposit fund or a pooled superannuation trust within the meaning of the *Superannuation Industry (Supervision) Act 1993* that has more than 100 members;

   (e) a trustee or management company of a prescribed interest scheme (other than a scheme under (d) above) which has net assets of not less than $10,000,000 and more than 100 members;

   (f) a trustee or management company of prescribed interest schemes when the trustee or management company has aggregate funds under management of not less than $50,000,000 and for each scheme under management there is:

      (i) not less than $10,000,000 funds under management; and
      (ii) more than 50 members;

   (g) a financial institution, building society or credit union under the Australian Financial Institutions Commission (AFIC) Codes;

   (h) an exempt public authority (see section 9 of the Corporations Law);

   (i) an 'investment company' as defined in reg 7.3.12(3) of the Corporations Regulations;

(j) a foreign entity which is registered under comparable overseas legislation (eg a registered US broker-dealer or a foreign life company or a bank); and

(k) the Commonwealth, any state or territory government, or any agency of a state or territory government or the Commonwealth.

2. There is debate about individuals of high net worth: there are some concerns as to whether such persons necessarily have, in all cases, the appropriate levels of investment experience and expertise and the capacity to seek their own remedies — see the extensive discussion of this issue in the CASAC report paragraphs 2.56-2.57. However, it has been suggested that persons with net tangible assets over $10 million should be excluded from the definition of retail investor.

3. If there is any doubt about whether or not a client comes within the proposed description of a retail investor, it would be prudent for a licencee to comply with the retail investor protection requirements for that client.

4. CASAC considers that the following persons should also be classified as wholesale participants:[131]

- all listed companies;
- related companies of listed companies that 'opt out' to being wholesale; and
- large proprietary companies.

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131 CASAC *Final Report on the Regulation of On-Exchange and OTC Derivatives Markets,* June 1997, paragraph 2.56 and pp 36-39.