Australian Government

Corporations and Markets Advisory Committee

Derivatives

Report

December 2011

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www.camac.gov.au

CAMAC's contact details are:

email: **camac@camac.gov.au**
fax: (02) 9911 2955
phone: (02) 9911 2950
mail: Corporations and Markets Advisory Committee
GPO Box 3967
Sydney NSW 2001

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Corporations and Markets Advisory Committee

Level 16, 60 Margaret Street, Sydney
Telephone: (02) 9911 2950
Email: camac@camac.gov.au

GPO Box 3967 Sydney NSW 2001
Facsimile: (02) 9911 2955
Website: www.camac.gov.au

22 December 2011

The Hon. David Bradbury MP
Parliamentary Secretary to the Treasurer
Parliament House
CANBERRA ACT 2600

Dear Mr Bradbury

I am pleased to present a report by CAMAC on the definition of derivative. The report responds to the matters you raised in the broader context of derivatives regulation, both within Australia and internationally.

Yours sincerely

Joanne Rees
Convenor

Contents

1 Introduction

This chapter sets out the terms of reference, outlines the review process and summarises the approach taken by CAMAC to the matters on which its advice has been sought.

1.1 Reference to the Committee

By letter of 18 November 2010, the Parliamentary Secretary to the Treasurer, the Hon. David Bradbury MP (the PST), requested CAMAC to consider a number of matters concerning the definition of derivative.

By way of background, the PST observed in the letter that:

> Subsection 761D(1) of the Corporations Act, in conjunction with the *Corporations Regulations 2001* (the Corporations Regulations), defines a derivative as an arrangement where:
>
> - a party must or may be required to provide consideration at some future time;
> - that future time is not less than three business days for foreign exchange contracts and one business day for all other arrangements; and
> - the amount of consideration or the value of the arrangement is determined by reference to something else.
>
> The Corporations Regulations also modify the 'future time' requirement in the Corporations Act and state that even if the consideration is required in less than one day, it will still be a derivative.
>
> The Corporations Act goes on to say that certain arrangements are excluded, such as the obligation to buy or sell tangible property. In essence it means that any contract to sell intangible property, whether for shares or debts, or whether for things not traditionally considered to be financial products (for example, intellectual property, royalties and statutory licences) will be a contract for a derivative for the purposes of the legislation.

Many derivative market participants regard physically settled forward contracts over shares as derivatives, primarily because the value of the forward contract varies by reference to the value of the shares, even though the price of the contract does not alter.

For example, a person could enter into a contract to purchase 1000 shares at $10 each to be physically settled in a week's time. Before delivery, the value of the shares could increase to $15 and the purchaser could sell the contract back to the issuer or a third party at a profit. The value of the contract, therefore, varies by reference to both the share price and the time value of money as reflected in the prevailing interest rate.

Under the present law, this contract is a derivative, since its value varied by reference to the value of the shares, as well as to the time value of money.

Treasury was considering an amendment to clarify the law, however, following targeted consultation, Treasury encountered concern that the amendment could have unintended consequences. The proposed amendment would have stated that an arrangement is not a derivative for the purposes of the Corporations Act if the arrangement would not be covered by the definition but for the fact that the value of the arrangement is ultimately determined by reference to the time value of money. However, stakeholders were concerned that the amendment might exclude physically settled forward contracts from the definition and add complexity to a highly technical area of the law. Treasury also encountered significant confusion surrounding section 761D generally and the implication that there may be significant non-compliance with the current legal requirements.

The lack of clarity as to what changes are required, coupled with confusion among industry participants, suggest that a wider review is required.

CAMAC was closely involved in the original development of the section (the definition of derivative in the Corporations Act is a result of a Companies and Securities Advisory Committee Report in June 1997: CASAC was the predecessor to CAMAC) and has the technical skills and knowledge required to appreciate both the legal meaning of the section and the ways in which it is currently applied and to assess possible ways of revising the definition.

The PST then requested CAMAC to:

- examine the definition of a derivative;
- examine the way in which such a definition may be changed to clarify the position of physically settled forward contracts; and
- suggest options to decrease complexity in this area of the law.

1.2 The review process

In approaching this review, CAMAC considered that it can best respond to the questions in the reference by taking into account the broader economic and commercial role of derivatives as financial instruments and, within that context, considering whether the current legislative structure properly regulates derivatives in the simplest manner possible.

As part of that process, CAMAC conducted a Roundtable of relevant peak bodies and industry participants, which was held on 30 September 2011. Participants included representatives from the ABA, AFMA, ANZ, the ASX, the Commonwealth Bank, Credit Suisse, Ernst & Young, Goldman Sachs, Henry Davis York, KPMG, Macquarie Bank, Mallesons Stephen Jaques, National Australia Bank, the Stockbrokers Association of Australia and Westpac, and Ian Shepherd. Representatives from Treasury, ASIC, APRA and the Department of Sustainability, Environment, Water, Population and Communities also attended.

The Roundtable provided an opportunity to discuss a range of general matters impinging on the role and regulation of derivatives, as well as specific definitional issues arising from the questions on which the PST sought advice.

CAMAC was greatly assisted in its consideration of issues related to derivatives by the information and views provided by Roundtable participants. The Committee expresses its appreciation to all who participated in this consultation process.

1.3 Outline of the report

Regulatory issues

Chapter 2 outlines the range of regulatory initiatives, both internationally and locally, that have been undertaken in response to issues concerning the operation of off-exchange (OTC) derivatives markets that were identified by the G20 group of countries following the onset of the global financial crisis some years ago. The chapter also outlines other Australian regulatory initiatives affecting derivatives, particularly in relation to retail participation in OTC derivatives markets.

Legislative framework

Chapter 3 examines the legislative framework for the regulation of on-exchange and OTC derivatives in Australia.

CAMAC considers that the Australian on-exchange and OTC derivatives markets are appropriately regulated through the general licensing and disclosure requirements applicable to all financial products, including derivatives, as well as the provisions specifically tailored for derivatives**.** This legislative approach generally aligns with market, consumer and regulatory expectations about their appropriate uses and regulation and compares well with overseas approaches.

While there are some differences between the regulation of derivatives and that of securities which could, at an appropriate time, be rationalised, there do not appear to be any fundamental difficulties or regulatory arbitrage opportunities that call for immediate rectification.

Definition of derivative

Chapter 4 examines the current legislative definition of derivative, comparing the approach in the Australian legislation with approaches in other jurisdictions.

CAMAC considers that s 761D of the Corporations Act suitably aligns with market and regulatory perceptions of what constitutes a derivative, and that no changes to the definition, or amendments in light of approaches adopted by overseas jurisdictions to the definition of derivative, are needed.

1.4 Advisory Committee

The Advisory Committee is constituted under the *Australian Securities and Investments Commission Act 2001*. Its functions include, on its own initiative or when requested by the Minister, to provide advice to the Minister about corporations and financial services law and practice.

The members of the Advisory Committee are selected by the Minister, following consultation with the States and Territories, in their personal capacity on the basis of their knowledge of, or experience in, business, the administration of companies, financial markets, financial products and financial services, law, economics or accounting.

The members of CAMAC are:

- Joanne Rees (Convenor)—Chief Executive Officer, Allygroup, Sydney
- Belinda Gibson—Deputy Chairman, Australian Securities and Investments Commission
- David Gomez—Principal, Merit Partners, Darwin
- Jane McAloon—Group Company Secretary, BHP Billiton Limited, Melbourne
- Alice McCleary—Company Director, Adelaide
- Denise McComish—Partner, KPMG, Perth
- Marian Micalizzi—Chartered Accountant, Brisbane
- Michael Murray—Legal Director, Insolvency Practitioners Association, Sydney
- Geoffrey Nicoll—Co-Director, National Centre for Corporate Law and Policy Research, University of Canberra
- Ian Ramsay—Professor of Law, University of Melbourne

- Robert Seidler AM—Consultant, Blake Dawson, Sydney
- Greg Vickery AM—Special Counsel, Norton Rose Australia, Brisbane.

A Legal Committee has been constituted to provide expert legal analysis, assessment and advice to CAMAC in relation to such matters as are referred to it by CAMAC.

The members of the Legal Committee are selected by the Minister, following consultation with the States and Territories, in their personal capacity on the basis of their expertise in corporate law.

The members of the Legal Committee are:

- Greg Vickery AM (Convenor)—Special Counsel, Norton Rose Australia, Brisbane
- Rosey Batt—Principal, Rosey Batt and Associates, Adelaide
- Lyn Bennett—Partner, Hunt & Hunt, Darwin
- Elizabeth Boros—Barrister-at-Law, Melbourne
- Damian Egan—Partner, Murdoch Clarke, Hobart
- Jennifer Hill—Professor of Law, University of Sydney
- James Marshall—Partner, Blake Dawson, Sydney
- David Proudman—Partner, Johnson Winter & Slattery, Adelaide
- Brian Salter— General Counsel, AMP, Sydney
- Rachel Webber—Special Counsel, Jackson McDonald, Perth.

The Executive comprises:

- John Kluver—Executive Director
- Vincent Jewell—Deputy Director
- Thaumani Parrino—Office Manager.

2 Regulatory issues

This chapter describes the nature of derivatives and the commercial and economic purposes that they serve. It also outlines ongoing international and local initiatives in the regulation of OTC derivatives markets, including in consequence of the global financial crisis.

2.1 Concept of a derivative

In general terms, a derivative is a financial instrument that derives its value from that of another, underlying, instrument or asset (such as a security or commodity) or a market variable (such as an interest rate, a currency exchange rate or a stock index). Parties to a derivatives contract agree to exchange cash or other consideration at a future time, based on the value of the underlying asset or market variable. A derivative can therefore be used to gain exposure to, or create an offset against, an underlying asset without either buying or selling that asset.

Derivatives contracts include forwards and options. A forward contract requires one of the contracting parties to buy, and the other to sell, an asset in the future for an agreed price, or to settle the contract by a cash payment. An option contract gives the buyer or holder of the option, in return for the payment of a premium, the right, but not the obligation, to buy or sell an asset in the future at an agreed price.

Fully standardised derivatives contracts are typically traded through organized trading facilities where prices are publicly disclosed (on-exchange derivatives). Derivatives tailored to the specific needs of the counterparties are typically traded off exchange on OTC markets, where parties deal directly with each other (or through their agents) and the prices and terms are privately settled.[1]

The types of derivatives traded on OTC markets around the world include credit derivatives (credit default swaps[2]) and interest rate, currency (foreign exchange[3]), market index, equity and commodity derivatives.[4] They take various forms, including 'rolling-spot contracts' and 'contracts for difference' (CFDs), and vary in their degree of complexity.

Participants in derivatives transactions can be end users or intermediaries. In the OTC market, end users can be financially large and sophisticated corporations, governmental entities, institutional investors, and banks and other financial institutions (wholesale participants) or persons with assets of lower value (retail participants).[5] Intermediaries in the OTC market, which may include

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1 The Treasury discussion paper *Handling and use of client money in relation to over the counter derivatives transactions* (November 2011) describes an OTC derivative as 'a financial contract negotiated bilaterally between the buyer and seller and which typically incorporates bespoke terms to allow the contracting parties either to hedge specific risks or generate tailored exposures. Examples of such OTC derivatives include swaps, contracts for difference (CFDs), margin foreign exchange and OTC options' (at Section 1.2).
Counterparties may tailor their terms within template documents, such as the single-jurisdiction or multiple-jurisdiction International Swaps and Derivatives Association (ISDA) Master Agreement.

2 The European Commission describes a credit default swap (CDS) in Europa *Regulation on Short Selling and Credit Default Swaps – Frequently asked questions* (19 October 2011) (MEMO/11/713 as:

> a derivative which is sometimes regarded as a form of insurance against the risk of credit default of a corporate or government (or sovereign) bond. In return for an annual premium, the buyer of a CDS is protected against the risk of default of the reference entity (stated in the contract) by the seller. If the reference entity defaults, the protection seller compensates the buyer for the cost of default.

3 The European Securities and Markets Authority (ESMA) publication *Investor warning: Trading in foreign exchange (forex)* (December 2011) (ESMA/2011/412) describes the foreign exchange market (also called the 'forex market', 'FX market' or 'currency market') as:

> a global financial market that trades in all the world's currencies. It is an international network with no fixed, physical location (i.e. it is 'decentralised'). It is an over-the-counter (OTC) market where brokers and dealers ('intermediaries') negotiate directly with one another.

4 A useful summary of the types, quantity, and value of OTC derivatives traded around the world is found in the report of the Bank for International Settlements *OTC derivatives market activity in the first half of 2011* (November 2011).

5 In the Australian context, s 761G of the Corporations Act sets out the various tests for distinguishing between a retail and a wholesale client of someone providing a financial product or financial service.

banks and securities firms, may quote bids and offers, and commit capital to satisfy customers’ demands for derivatives.

Derivatives can be used by companies or individuals to manage or hedge risks associated with their business, such as movements in interest rates, currencies and commodity prices. OTC derivatives, being bilateral arrangements, can be tailored to meet the specific requirements of the parties. However, transacting in derivatives can also involve substantial financial risks for participants.[6]

As summed up by the European Commission:

> Derivatives are financial contracts that trade and redistribute risks generated in the real economy, and are accordingly important tools for economic agents to transfer risk. They can accordingly be used for insuring against risk (hedging). However, derivatives have increasingly become used to acquire risk with the aim of making a profit (speculation and arbitrage). An important feature of derivatives is that they allow those who use them to obtain leverage: with a relatively small outlay, the investor is able to take a large position in the market.[7]

2.2 Market, consumer and regulatory expectations

2.2.1 The economic and commercial role of derivatives

The Companies and Securities Advisory Committee (CASAC),[8] in its 1997 report *Regulation of On-exchange and OTC Derivatives Markets* (the CASAC report), stated that:

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6 The European Securities and Markets Authority (ESMA) publication *Investor warning: Trading in foreign exchange (forex)* (December 2011) (ESMA/2011/412) contains a useful summary of the risks for retail participants in the FX market, arising from the complexity of some forex products, the potential volatility of these markets and the effects of leverage.
Useful summaries, and explanations, including the risks, of various types of derivatives available in the Australian exchange and OTC markets, including futures and options, foreign exchange trading and contracts for difference, are found on the ASIC website **moneysmart.gov.au**.

7 Europa *Derivatives Markets - Frequently Asked Questions* (3 July 2009) (MEMO/09/314).

8 In 2002, the name was changed to the Corporations and Markets Advisory Committee (CAMAC).

Derivatives have several important functions in the financial market, including:

- *Risk management.* Derivatives may be a very cost-effective, efficient and expeditious way to transfer, hedge or adjust a financial risk or an exposure, or provide cash flow or price certainty. They may protect an asset against, or minimise a liability from, fluctuating market values or costs, for instance, in commodities, equities, currencies, units of energy, interest rates or other financial variables. Derivatives can reduce uncertainty about future profitability. They may also protect credit providers against default risks or undue credit concentrations.

- *Diversification.* Derivatives can be used to diversify a financial portfolio.

- *Completing markets.* Derivatives can be constructed to unbundle or redesign existing financial market instruments and therefore offer market participants risk and return patterns that were previously unavailable, or too costly, to them on financial markets.

- *Achieving transactional efficiency.* Acquiring a derivative over an asset may be more cost-effective and quicker than buying that asset. For instance, a person with the funds to buy a share portfolio may instead purchase a share price index future, enter into an equity swap arrangement or acquire individual share futures. All these transactions represent some risk-taking on the future movement in share prices. However, a derivative which replicates a physical transaction may be entered into more quickly and with lower initial outlay, transaction costs and administrative charges.

- *Reducing volatility.* Derivatives markets for some products may be more liquid than the physical markets for those products and therefore be less vulnerable to the effect on pricing of individual trading.

- *Arbitrage.* Derivatives may be used to capture profits based on pricing anomalies, or product gaps, between different financial markets. This helps to enhance market efficiency.

- *Speculation.* Derivatives may be used by persons who have no direct interest in the subject matter of the derivative. Their involvement adds depth and liquidity to derivatives markets.[9]

Through these various processes, derivatives can provide a critical underpinning to investment, capital raising and financial risk-taking, and thereby advance the Australian economy as a whole.

2.2.2 Goals of regulating derivatives

The CASAC report indicated that one of the key regulatory concerns at that time was to ensure that the Australian on-exchange and OTC derivatives markets worked efficiently and equitably while remaining globally competitive. The report indicated that these goals could be met through specific prudential, disclosure and other regulatory mechanisms to achieve or maintain:

- market stability
- market symmetry and regulatory simplification
- appropriate intermediary-client arrangements
- retail participant protection
- trading integrity.[10]

In regard to market stability, the CASAC report indicated that the regulatory goal was not to remove the inevitable financial risk to participants of transacting in derivatives, but to concentrate on how to deal with core risk elements that, depending upon the level of failure by participants within derivatives markets or failure contagion between markets, could undermine the stability of financial markets generally.

In the on-exchange and OTC derivatives markets, the core market stability risk elements identified in the CASAC report were:

- *market or position risk*. This is the risk of adverse movements in the value of derivatives contracts in consequence of changes in

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9 para 1.4.
10 paras 2.25 – 2.73.

the market price or value of the underlying asset. An unduly high level of defaults could affect overall market stability

- *counterparty credit risk*. This is the risk that a party will default on its obligations under the derivatives contract. That risk is borne by the clearing house for on-exchange derivatives transactions and by the counterparties in OTC derivatives transactions

- *large exposure risk.* This is an extension of counterparty credit risk. Failure by one or more major participants in OTC markets, in addition to adversely affecting counterparties, could generate systemic risks for those, or related, markets

- *market liquidity risk.* This is the risk that a particular derivatives market may lack sufficient depth of trading to facilitate efficient entry into and exit from that market. Participants may be unable (at all or at a reasonable price) within a reasonable time, to unwind or offset particular derivatives transactions because of inadequate depth of trading

- *operational risk.* This is the risk that large market participants may suffer losses, with adverse consequences for the market generally, through the lack of effective internal risk management systems

- *legal risk*. This is the risk that a counterparty's performance obligations are legally unenforceable, for instance that the transaction breaches regulatory prohibitions or fails to comply with regulatory obligations. That risk is borne by the clearing house for on-exchange derivatives transactions, and by counterparties in OTC derivatives transactions.[11]

Similar market stability risks have been identified in overseas reports following the onset of the global financial crisis. For instance, the UK House of Lords paper *The future regulation of derivatives markets* (2010) summarised three principal risks, particularly with OTC derivatives markets, which became evident in recent years:[12]

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11 paras 2.27 – 2.45.
12 paras 28-32.

[*Lack of Transparency*] Lack of transparency has been highlighted as a key risk in the OTC derivatives market. A joint HM Treasury and Financial Services Authority paper, *Reforming OTC derivatives markets*, noted that "positions and exposures of firms in OTC derivatives markets were not sufficiently transparent to other market participants or to regulators." Market participants were unaware of overall market positions and build-ups in risk. This lack of transparency in relation to overall exposures can lead to an unwillingness to trade in a falling market and so reduce market liquidity. J.P. Morgan noted that the lack of information available to supervisors prevented proper supervision taking place. The lack of transparency means that supervisors are not able to monitor or mitigate systemic risks effectively.

[*Counterparty risk*] In addition to the lack of transparency, the main risk associated with derivatives contracts is counterparty risk, that is, the risk that a counterparty in a derivatives contract will not satisfy its obligations under the contract, for example, by failing to supply goods in a futures contract. This could cause major problems to a counterparty that would be left suddenly without a derivatives contract and no longer receiving payments under the contract. The Managed Funds Association (MFA) explained to us that in practice large market participants use various techniques, including the posting of collateral either through mark-to-market margins (variation margin) and upfront margins (initial margin), to reduce counterparty risk to which they are exposed. The MFA explained that both operational and systemic risks affect derivatives contracts. Operational risks are those that occur from human error or the failure of control systems. The MFA considered that the elimination of large backlogs of unconfirmed derivatives, standardised contract terms for OTC derivatives, improved processes and procedures for the physical settlement of underlying assets, and procedures for addressing valuation disputes have helped reduce operational risks.

[*Systemic risk*] Systemic risk describes the risk to the financial system posed by the default of a major player in the derivatives market. Interlinkages in the market created by the large number of derivatives contracts means that the default of one party can have far-reaching implications for the creditworthiness of its counterparties. The Investment Management Association (IMA) referred to the "domino effect" caused by "financial firms connected through non-transparent OTC derivatives contracts." Unmitigated, this can lead to systemic risk. This is clearly affected by the size of the counterparty: the larger the counterparty, the

> greater effect its default causes on the market as a whole. Credit default swaps (CDS) are highlighted by the [European Commission] as “particularly vulnerable” to these risks. The risk associated with the underlying asset of a CDS, credit risk, is much more difficult to assess as only banks have access to specific information on the borrower, often leading to the underpricing of risk on CDS products. The complexity and opacity of CDS products makes it difficult for supervisors to spot dangerous distributions of risk.

2.3 International regulatory developments

The operation of derivatives markets in various jurisdictions has come under close scrutiny in recent years in the wake of the global financial crisis.

Concerns were directed in particular at the complexity and lack of transparency of various OTC derivatives markets, which reduced the ability of participants and regulators to identify the risks that could undermine market stability. Also, the inter-linkages that derivatives contracts created in the financial system were blamed for spreading problems between financial institutions.

Some of the international dimensions and ramifications of these matters were summed up by the Chairman of the United States Commodity Futures Trading Commission (CFTC):

> … while the [global financial] crisis had many causes, it is evident that unregulated [OTC] derivatives, called swaps [in the US], played a central role. Developed in the 1980s, swaps, along with the regulated futures market, help producers, merchants and companies lower their risk by locking in the price of a commodity, interest rate, currency or other financial index. Our nation’s economy relies on a well-functioning derivatives market – an essential piece of a healthy financial system.
>
> But over the last thirty years, the unregulated swaps market grew by orders of magnitude and is now seven times the size of the futures market. During its growth, the market lacked the transparency of the futures and securities markets, and risk accumulated. Swaps, which were developed to mitigate and spread risk, actually added leverage to the financial system – with more risk backed by less capital.

> Swaps also contributed significantly to the interconnectedness between banks, investment banks, hedge funds and other financial entities. Large financial institutions once regarded as too big to fail were also regarded as too interconnected to fail. Swaps concentrated and heightened risk in the financial system and to the public.[13]

2.3.1 Group of 20 countries

In response to negative developments in global financial markets following the onset of the global financial crisis in 2008, the Group of 20 countries (G20)[14] meeting in September 2009 agreed that:

- all standardised OTC derivative contracts should be traded on exchanges or through electronic trading platforms, where appropriate, and cleared through central counterparties (CCPs) by the end of 2012
- OTC derivative contracts should be reported to trade repositories
- non-centrally cleared derivatives contracts should be subject to higher capital requirements.[15]

At subsequent G20 meetings, the participating countries reaffirmed their commitment to strengthening financial market infrastructure, including by accelerating the regulatory oversight of OTC derivatives in an internationally consistent and non-discriminatory way, while avoiding loopholes and overlapping regulation:

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13 CFTC Chairman Gary Gensler in his *Remarks at a Conference hosted by the Office of Financial Research and the Financial Stability Oversight Council,* 2 December 2011. The financial consequences for banks and other financial institutions of over-exposure to certain credit default swaps and other OTC derivatives in the period leading up to the global financial crisis are also summarised in the UK Financial Services Authority Board Report *The failure of the Royal Bank of Scotland* (December 2011) Part 1 paras 19-26 (Losses in credit trading activities).

14 The G20 comprises Argentina, Australia, Brazil, Canada, China, the European Union, France, Germany, India, Indonesia, Italy, Japan, Mexico, Russia, Saudi Arabia, South Africa, the Republic of Korea, Turkey, the United Kingdom and the United States of America.

15 G20 Leaders' Statement: The Pittsburgh Summit, 24-25 September 2009, para 13 under the heading *Improving over-the-counter derivatives markets*. The thinking behind these principles is usefully summed up by the European Commission in *Derivatives Markets - Frequently Asked Questions* (3 July 2009) (MEMO/09/314).

> Reforming the over the counter derivatives markets is crucial to build a more resilient financial system.[16]

In response to the G20 agreements, a series of reviews were initiated concerning the regulation of OTC derivatives markets (see below). This process is ongoing, and is in addition to the legislative changes in the United States regarding the regulation of financial markets, including derivatives.

2.3.2 Financial Stability Board

The Financial Stability Board (FSB) was established to coordinate at the international level the work of national financial authorities and international standard-setting bodies and to develop and promote the implementation of effective regulatory, supervisory and other financial sector policies in the interest of financial stability.[17]

The G20 requested the FSB regularly to assess the implementation of the G20 agreements aimed at improving OTC markets.

In October 2010, the FSB published a report *Implementing OTC Derivatives Market Reforms*. The report responded to calls by the G20 to improve the functioning, transparency and regulatory oversight of OTC derivatives markets.

In October 2011, the FSB published *OTC Derivatives Market Reforms: Progress report on Implementation.* The report provides a detailed review of progress in various jurisdictions toward meeting the G20 commitments concerning OTC derivatives. For each of these commitments, the report provides an assessment of progress in the various jurisdictions, including implementation through changes in market practices.

The FSB will continue this monitoring process and report to the G20 in 2012 about progress in the implementation of the G20 recommendations concerning OTC derivatives, as well as other

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16 G20 Cannes Summit Final Declaration, 4 November 2011, para 24.

17 The FSB brings together national authorities responsible for financial stability in 24 countries and jurisdictions, international financial institutions, sector-specific international groupings of regulators and supervisors, and committees of central bank experts. The FSB Secretariat is located in Basel, Switzerland, and is hosted by the Bank for International Settlements (BIS).

financial regulatory reforms.[18] The FSB has established a coordination group to avoid loopholes and overlapping regulation of OTC derivatives between jurisdictions.[19]

The FSB has also been asked by the G20 to coordinate work by the regulatory community on developing a global legal entity identifier (LEI) that identifies parties to derivative and other financial transactions.[20]

2.3.3 IOSCO

The International Organization of Securities Commissions (IOSCO), through the work of its Technical Committee in conjunction with other international bodies, has given close consideration to various aspects of derivatives markets.

In October 2010, IOSCO formed a Task Force on OTC Derivatives Regulation, to coordinate the efforts of securities and futures regulators in various jurisdictions to work together in the development of supervisory structures related to OTC derivatives markets.

In February 2011, IOSCO published the Task Force's *Report on Trading of OTC Derivatives.* The report analysed the benefits, costs and challenges associated with increasing exchange and electronic trading of OTC derivative products and contained recommendations to assist the transition of trading in standardised derivatives products from OTC venues to exchanges and electronic trading platforms (organized platforms) while preserving the efficacy of those transactions for counterparties. The report also urged coordinated regulatory action to avoid the possibility of regulatory arbitrage.

In response to a recommendation in the FSB report *Implementing OTC Derivatives Market Reforms* (October 2010), IOSCO and the Bank for International Settlements (BIS) Committee on Payment and Settlement Systems, in August 2011, released for comment the *Report on OTC derivatives data reporting and aggregation*

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[18] FSB Press release of 4 November 2011 *Financial Stability Board reports to G20 Leaders on progress in implementing financial regulatory reforms.*
[19] G20 Cannes Summit Final Declaration, 4 November 2011, para 24.
[20] G20 Cannes Summit Final Declaration, 4 November 2011, para 31.

requirements. This consultative report deals with derivatives trading data that should be collected, stored and disseminated by trade repositories. The purpose of collecting these data is to make OTC derivatives markets more transparent, help to prevent market abuse, and promote financial stability. The report also covers the mechanisms and tools that authorities will need to aggregate these data. The final version of the report is expected to be published in early 2012.

In September 2011, IOSCO published a report *Principles for the Regulation and Supervision of Commodity Derivatives Markets.* That report was in response to a request by the G20 in November 2010 for further work on the regulation and supervision of commodity derivatives markets. That report was endorsed by the G20 in November 2011, with a request that IOSCO report on the implementation of its recommendations by the end of 2012.[21]

Several international bodies, being IOSCO, the Basel Committee on Banking Supervision, the BIS Committee on the Global Financial System and the BIS Committee on Payment and Settlement Systems, are coordinating the development of internationally uniform margin requirements for non-standard OTC derivatives transactions that cannot be centrally cleared. The group is developing standards to be released for consultation by mid-2012.

IOSCO and the BIS Committee on Payment and Settlement Systems are also developing principles for financial market infrastructures.

In addition, IOSCO has been asked by the G20 to assess the functioning of credit default swap markets, and the role of those markets in price formation of underlying assets.[22]

2.3.4 BIS Committee on the Global Financial System

The report of the BIS Committee on the Global Financial System *The macrofinancial implications of alternative configurations for access to central counterparties in OTC derivatives markets* (November 2011) noted that the G20 commitment to central clearing of all standardised OTC derivatives by the end of 2012 is intended to

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21 G20 Cannes Summit Final Declaration, 4 November 2011, para 32.
22 G20 Cannes Summit Final Declaration, 4 November 2011, para 31.

increase the safety and resilience of the global financial system. Various alternative arrangements are under consideration for the central clearing of OTC derivatives trades. Several jurisdictions are exploring the establishment of domestic central counterparties (CCPs) and the possible benefits of establishing links between them. The conditions under which market participants obtain access to central clearing could have important implications for financial stability and efficiency.

The report concludes that:

- expanding direct access to CCPs may reduce the concentration of risk in the largest global dealers. As direct access is broadened, it is essential that the risk management procedures of CCPs be adapted appropriately to ensure their continued effectiveness
- both large global and smaller regional or domestic CCPs will probably play a role in meeting G20 commitments. In both cases, developing and adopting international standards will be essential to avoid regulatory arbitrage and promote effective cross-border monitoring of infrastructure and participants
- CCPs and authorities should consider enhancements where needed to strengthen the safety and efficiency of indirect clearing. Effective segregation, as well as portability of positions and collateral belonging to a direct clearer's clients, will be needed to realise the benefits of systemic risk reduction.

2.3.5 Basel Committee on Banking Supervision

The Basel Committee consultative document *Capitalisation of bank exposures to central counterparties* (November 2011) sets out proposals for capital standards to encourage banks to clear their OTC derivative positions through CCPs. It is proposed that exposures to a CCP will be afforded less weighting for the purpose of a bank's capital requirements than bilateral counterparty exposures. Banks with considerable bilateral OTC derivatives exposures will therefore have an incentive to move to greater CCP clearing over time.[23]

The Basel Committee consultative document *Core Principles for Effective Banking Supervision* (December 2011) has implications for banks involved in derivatives trading. For instance, the core principles include that banks have prudent policies and processes to identify, measure, evaluate, monitor, report and control or mitigate credit risk, including counterparty credit risk exposures from transacting in OTC derivatives.[24]

2.3.6 European Commission

The European Commission is a central institution of the European Union (EU). It drafts proposals for new EU laws (which may take the form of Regulations or Directives) and implements EU policies.

During 2009-10, the European Commission published a series of communications on *Ensuring efficient, safe and sound derivatives markets*, focusing on OTC markets. The Commission argued in one of those Communications that the financial crisis had shown:

> that the characteristics of OTC derivative markets—the private nature of contracting with limited public information, the complex web of mutual dependence, the difficulties of understanding the nature and level of risks—increase uncertainty in times of market stress and accordingly pose risks to financial stability.[25]

The Commission identified four principal policy goals:

- to enable regulators and supervisors to have an overview of the transactions that take place in OTC derivatives markets
- to increase the transparency and visibility of OTC derivatives

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23 The statement by the Basel Committee *High cost credit protection* (16 December 2011) identifies other factors to take into account to ensure that the costs, as well as the benefits, of purchased credit protection through guarantees or credit derivatives are appropriately recognised in regulatory and other capital adequacy assessments of banks.

24 Principle 17. See also the Basel Committee consultative document *Application of own credit risk adjustments to derivatives* (December 2011).

25 COM(2009) 332 final (3 July 2009).

- to strengthen the operational efficiency of derivatives markets so as to ensure that OTC derivatives do not undermine financial stability, and
- to mitigate counterparty risks.

Draft Regulation

In September 2010, the European Commission published a proposed regulation, known as the European Market Infrastructure Regulation (EMIR), aimed at bringing more stability and transparency to OTC derivatives markets. If enacted in its current form, the draft regulation would require that:

- in general, standard OTC derivative contracts be cleared through central counterparties (CCPs), with rules to establish interoperability between CCPs
- measures be introduced to reduce counterparty credit risk and operational risk for bilaterally cleared OTC derivatives
- information on OTC derivative contracts be reported to trade repositories and be accessible to supervisory authorities
- more information be made available to all market participants.[26]

The Commission's proposed regulation, intended to be in line with the EU's G20 commitments and the approach adopted by the United States in the Dodd-Frank Act (see below), has gone to the European Parliament and the EU Member States for consideration. The intention is that the regulation, as finally agreed, will apply from the end of 2012.

Draft revised Directive

In October 2011, following a consultation process, the European Commission published proposals to revise the *Markets in Financial Instruments Directive* (MiFID), in force since 2007. The proposals aim to make financial markets more efficient, resilient and transparent, and to strengthen the protection of investors. The new framework will also increase the supervisory role of the European

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26 *Proposal for a Regulation of the European Parliament and of the Council on OTC derivatives, central counterparties and trade repositories* (September 2010).

Securities and Markets Authority (ESMA) (which commenced operation in January 2011). Matters affecting derivatives include:

- the establishment of a new category of 'organised trading facilities' (OTF) which will require specific authorisation and which will be subject to trading venue rules (for instance, relating to organisation and transparency)
- stronger supervision of commodity derivatives markets, including a position reporting obligation by category of trader and empowering financial regulators to monitor and intervene at any stage in trading activity in all commodity derivatives, including by setting position limits[27] if there are concerns about disorderly markets
- ESMA and financial regulators, under defined circumstances, will be able to ban specific products, services or practices in case of threats to investor protection, financial stability or the orderly functioning and integrity of financial markets.[28]

The proposals go to the European Parliament and the EU Member States for consideration.

2.3.7 France

Consideration has been given in a number of jurisdictions to issues concerning the marketing of derivatives to retail participants.

For instance, in October 2010, the Autorité de contrôle prudentiel (ACP) and the Autorité des marchés financiers (AMF) released *Position AMF n° 2010-05 relative à la commercialisation des instruments financiers complexes* (*Marketing complex financial instruments to the public*).

That paper noted the development of particularly complex financial instruments, including some derivatives, that are sold to retail investors and whose risks are hard for the general public to

27 Position limits would prohibit a trader from holding a derivatives position above a specified limit unless the trader was granted an exemption, which could, for instance, be based on hedging activity.

28 See further the speech by S Maijoor, Chair of ESMA, given at the EFAMA Investment Management Forum on 29 November 2011 (ESMA/2011/404).

understand. The paper set out four criteria to determine whether the products to be marketed are likely to cause investors to underestimate the risks involved or even to misunderstand the product. The criteria are:

- poor presentation of the risks or potential losses, especially when the product's performance is sensitive to extreme scenarios
- underlyings that are hard to identify or impossible to observe individually on the markets
- gains or losses that depend on simultaneous occurrence of several conditions across different asset classes
- multiple mechanisms incorporated into the formula used to compute gains or losses at maturity.

The paper recommended enhanced disclosure obligations by intermediaries relating to the nature of the financial instruments and the risks involved.

2.3.8 United States

The law regulating financial markets in the United States is an amalgam of two statutes, the *Commodities Exchange Act* and the *Securities Exchange Act*. The Commodity Futures Trading Commission (CFTC) administers the former Act and the Securities and Exchange Commission (SEC) administers the latter Act. The SEC regulates securities derivatives, while the CFTC regulates other derivatives.

Title VII of the *Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010* (the Dodd-Frank Act) imposes new regulations on the 'swaps' (OTC derivatives) market.[29] The legislation is designed to improve oversight of, and promote greater transparency and stability in, these markets. For instance:

29 Title VII of the Dodd-Frank Act has been implemented in a number of stages. In July 2011, the CFTC granted temporary exemptive relief from certain provisions of the Act applicable to swap regulation that otherwise would have taken effect from July 2011, the general effective date of Title VII. On 19 December 2011, the CFTC issued a Final Order, extending the potential latest date of the exemptive relief to July 2012.

- *traders:* those market participants that fit within the Act's definition of 'swap dealer' or 'major swap participant' will be required to register with the CFTC or the SEC

- *trading:* standardised swaps are to be traded on a registered exchange or swap execution facility (SEF), with transactions being publicly reported as soon as technologically practicable after their execution. There are also record-keeping requirements for all swap transactions

- *central clearing:* standardised swaps are to be cleared through a central clearing house

- *capital and margin requirements:* both the CFTC and the SEC are authorised to write rules that will set capital and margin requirements for swap dealers and major swap participants, to offset risks from the use of non-standardised swaps that cannot be centrally cleared.

In addition, the CFTC is directed under the Dodd-Frank Act to develop position limits 'as appropriate' for commodity derivatives.

In September 2010, the CFTC and the European Commission issued a joint statement about regulatory reform of the OTC derivatives markets arising from the Dodd-Frank Act and the September 2010 European Commission draft Regulation (see Section 2.3.6). The issues discussed included:

- comprehensively regulating derivatives dealers for capital and margin, recordkeeping and reporting and business conduct standards

- requiring standardised OTC derivatives to be cleared by central counterparties (CCPs), which would be subject to prudential and organization rules, and imposing risk mitigation standards for non-standardised contracts that are not centrally cleared, and

- increasing transparency of OTC derivatives.

An ongoing consultation process has been established between the European Commission, the European Securities and Market

Authority (ESMA), the CFTC, the SEC and other authorities responsible for the regulation of OTC derivatives markets in various jurisdictions.[30]

Throughout 2011, US regulators considered a range of regulatory measures to implement the Dodd-Frank Act requirements concerning OTC derivatives on such matters as:

- who can become a CCP member
- which OTC derivatives contracts are sufficiently standardised for mandatory central clearing
- mandatory trading platforms
- mandatory trade reporting
- capital and margin requirements for uncleared swaps
- position limits for certain commodity derivatives.[31]

2.3.9 Canada

In October 2010, the Canadian OTC Derivatives Working Group published a discussion paper, *Reform of Over-the-Counter (OTC) Derivatives Markets in Canada*, which set out preliminary recommendations for implementing Canada's G20 commitments related to OTC derivatives. The recommendations covered:

- capital incentives and standards
- standardisation

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30 OTC Derivatives Regulators' Forum; ESMA *Global regulators discuss OTC derivatives regulation* (9 December 2011) (ESMA/2011/431).

31 A summary of developments in the US is provided by CFTC Commissioner Scott D. O'Malia in his *Keynote Address of the 7th Annual FIA Asia Derivatives Conference* (Singapore), 30 November 2011, and by CFTC Chairman Gary Gensler in his *Remarks at a Conference hosted by the Office of Financial Research and the Financial Stability Oversight Council*, 2 December 2011. See also CFTC Chairman Gary Gensler, *Opening Statement Before a Meeting of the Commodity Futures Trading Commission, Washington, DC* (20 December 2011) and CFTC Commissioner Scott D. O'Malia, *Opening Statement, Open Meeting on Final Rules on Swap Data Recordkeeping and Reporting Requirements and Real Time Reporting* (20 December 2011). All these documents are available on the CFTC website.

- central counterparties and risk management
- trade repositories
- trading venues.

Also, in November 2010, the Canadian Securities Administrators released Consultation Paper 91-401 *Over-the-Counter Derivatives Regulation in Canada*. This paper focuses on the regulatory tools required to monitor and regulate the OTC derivatives market.

Work on these matters continued throughout 2011. For instance, in June 2011, the Canadian Securities Administrators (CSA) published Consultation Paper 91-402 *Derivatives: Trade Repositories*, which sets out a series of recommendations designed to improve regulatory oversight of OTC derivatives transactions, while maintaining consistency with international developments. In November 2011, the CSA published Consultation Paper 91-403 *Derivatives: Surveillance and Enforcement*, containing proposals to improve regulatory oversight of OTC derivatives transactions in Canada, also consistent with international developments. These Papers are part of a series of documents building on the regulatory proposals contained in Consultation Paper 91-401 on OTC derivatives regulation in Canada.

2.3.10 Hong Kong

In October 2011, the Hong Kong Monetary Authority (HKMA) and the Securities and Futures Commission (SFC) issued their *Consultation paper on the proposed regulatory regime for the over-the-counter derivatives market in Hong Kong*.

The HKMA and SFC have been working on developing a regulatory regime for the OTC derivatives market in Hong Kong in accordance with the G20 commitments.

The proposed regime aims to improve overall transparency in the OTC derivatives market in Hong Kong and generally reduce systemic risk in the financial system. To achieve this, the consultation paper sets out various proposals, including:

- a requirement for OTC derivatives transactions to be reported to a trade repository, to be set up by the HKMA

- a requirement for standardised OTC derivatives transactions to be centrally cleared through a designated central counterparty (Hong Kong Exchanges and Clearing Limited announced in December 2010 that it had decided to establish a clearing house in Hong Kong for the clearing of OTC derivatives transactions)
- enhanced licensing requirements for intermediaries that engage in OTC derivatives activities.

It is also proposed that market participants who engage in large derivatives transactions but who are not currently regulated by the HKMA or the SFC may be subject to certain obligations and requirements, such as producing information regarding their OTC derivatives activities, and reducing their OTC derivatives positions, if so requested by the SFC in extreme situations.

The HKMA and the SFC are working towards meeting the G20 implementation deadline of the end of 2012.

2.4 Australian regulatory developments

2.4.1 Survey

In May 2009, ASIC, APRA and the Reserve Bank of Australia (RBA) published a *Survey of the OTC Derivatives Market in Australia*. The survey found that the size of exposures in the Australian market was relatively low by international standards and that this market remained ‘robust’ throughout the global financial crisis.

The survey also identified a number of areas in which practices in Australian OTC derivatives markets might be enhanced. Many of the recommendations made in the survey mirror the initiatives being undertaken at an international level, such as:

- greater standardisation of OTC derivatives
- the use of electronic trading platforms and central counterparties, and
- the greater use of collateral to mitigate counterparty credit risk in bilateral counterparty exposures.

2.4.2 Council of Financial Regulators

In June 2011, the Council of Financial Regulators (comprising the RBA as chair, APRA, ASIC and Treasury) issued a discussion paper *Central Clearing of OTC Derivatives in Australia* as part of its consideration of Australia's response to the international reform efforts under way concerning OTC derivatives markets in response to the G20 agreement.

The paper discussed the evolving global landscape for OTC derivatives and central clearing, the Australian market for OTC derivatives, and a range of considerations that need to be weighed if central clearing in the domestic market is to be established.[32]

The Council sought submissions on the discussion paper and held a series of Roundtables of interested parties in the second half of 2011.

The Council, in its discussion paper, also indicated that it is considering other aspects of the G20 agreement and will develop recommendations to the Government on these matters in due course.

2.4.3 ASIC

ASIC has also been active in the regulation of derivatives, including various OTC derivatives directed at the retail market.

ASIC Regulatory Guide 212 *Client money relating to dealing in OTC derivatives* (July 2010) provides an overview of the regulatory structure for the identification and permitted use of client money, in particular, in relation to derivatives. It also aims to assist retail investors properly to understand counterparty credit risks when trading in OTC derivatives.

ASIC Regulatory Guide 168 *Disclosure: Product Disclosure Statements (and other disclosure obligations)* (September 2010) reflects key findings from ASIC Report 201 *Review of disclosure for*

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32 A useful summary of the issues in the Australian context is given by M Edey, Assistant Governor (Financial System), RBA in his Address to the ISDA Annual Australia Conference *The Challenge of Central Clearing in OTC Derivatives Markets* (20 October 2011).

capital protected products and retail structured or derivative products (July 2010).[33]

In May 2011, ASIC released Consultation Paper 156 *Retail OTC derivative issuers: Financial requirements* (CP 156) to seek feedback on the financial requirements for issuers of OTC derivatives, such as contracts for difference or margin foreign exchange, to retail investors. CP 156 aims to ensure that issuers of retail OTC derivatives have adequate financial resources to manage their operating costs and risks and that the owners of issuers are committed to the viability of the business.

ASIC Regulatory Guide 227 *Over-the-counter contracts for difference: Improving disclosure for retail investors* (August 2011) deals with the issue, sale or advertising of OTC contracts for difference (CFDs), margin forex and similar products to retail investors. It sets out guidelines for improved disclosure to retail investors to help them understand and assess these products. It also provides guidance on the advertising of OTC CFDs to retail investors. ASIC observes that the Guide may also be of interest to issuers of exchange-traded CFDs.[34]

ASIC Consultation Paper 167 *Advertising financial products and advice services: Good practice guidance* (August 2011) contains proposals on best practice guidance for financial service companies, including when promoting financial products such as CFDs and providing advice concerning those products. It includes a draft regulatory guide.

ASIC also provides information on derivatives (including the inherent risks involved in transacting in CFDs and other complex products) on its website **moneysmart.gov.au**.

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33 See also ASIC Report 205 *Contracts for difference and retail investors* (July 2010).

34 See also ASIC Report 246 *Response to submissions on CP 146 OTC CFDs: Improving disclosure for retail investors* (August 2011) and the article by the ASIC Chairman G Medcraft 'Don't be tempted into the CFD danger zone' *The Australian*, 3 November 2011.

2.4.4 APRA

The role of APRA as a prudential regulator includes the supervision of various aspects of the use of derivatives by its supervised institutions. APRA has provided direction and guidance on derivatives-related matters in various publications, including Prudential Practice Guide *SPG 200 Risk management* (August 2010).

2.4.5 Treasury

The Treasury discussion paper *Handling and use of client money in relation to over-the-counter derivatives transactions* (November 2011) raises issues relating to the holding of client money in connection with OTC derivatives transactions and whether the client money provisions of the Corporations Act provide sufficient protections for investors. The paper sets out a number of options to reform the regulation of retail client funds.

2.4.6 Draft legislation

The proposed Future of Financial Advice (FOFA) legislation[35] would have various consequences for the marketing of derivatives. For instance, it includes a 'best interests' duty on persons providing financial advice, which may have implications for recommending certain types of derivatives to retail clients.

2.5 CAMAC comments

Derivatives have a clearly recognised role in financial markets as risk management products. The ability of market participants to enter into on-exchange derivatives, or standardised or customised OTC derivatives, can be a key means of prudently managing business, operational or investment risks, though transacting in derivatives can also involve financial and other risks for participants. The level and types of trading in some overseas OTC derivatives markets in recent years have also generated concerns about global financial market stability, resulting in international initiatives, led by the G20 countries, to reform aspects of OTC markets.

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35 The Corporations Amendment (Future of Financial Advice) Bill 2011 and the Corporations Amendment (Further Future of Financial Advice Measures) Bill 2011.

CAMAC notes the conclusions of the Australian regulators in their 2009 survey that the Australian OTC derivatives market has demonstrated robustness during the global financial crisis and that no systemic risks to that market were apparent. CAMAC recognises the continuing work of the Council of Financial Regulators, in consultation with industry groups and other interested parties, in regard to central clearing and other matters affecting the Australian OTC derivatives market in response to the G20 agreement, and also notes the disclosure and other regulatory initiatives undertaken by ASIC, APRA and Treasury.

CAMAC has developed the views in this report in the context of the continuing debate on whether there should be some suitability or other controls (up to and including banning) on the access of unsophisticated participants (retail investors) to certain complex OTC derivatives. There is currently discussion internationally and locally on whether some suitability criteria should be adopted.

3 Legislative framework

This chapter describes the structure for regulating derivatives under the licensing and other relevant provisions of the Corporations Act and compares the regulation of derivatives and securities.

3.1 Derivative as a financial product

A derivative is one of a wider class of things that fall within the legislative concept of a 'financial product' for the purposes of Chapter 7 (Financial services and markets) of the Corporations Act. This financial product concept is further outlined in the Appendix to this report.

If a financial product that is covered by the definition of derivative in s 761D is also within another category of financial product, such as a 'security',[36] it is treated as that other type of financial product, not a derivative.[37] This definitional 'trumping' arrangement was proposed in the CASAC report as a means of overcoming the possibility of double regulation of those financial products that could satisfy both the definition of security and the definition of derivative.[38] The category of financial product most likely to 'trump' derivatives is securities, which have their own system of regulation (see Section 3.4).

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36 'Security' is defined in s 761A for the purposes of Chapter 7 (financial services and markets). The term 'securities' is defined in s 700 for the purpose of Chapter 6D (fundraising). Section 92 contains a slightly different definition of 'securities' for other purposes.

37 s 761D(3)(c), which refers to s 764A(1) (specific things that are financial products).

38 CASAC report paras 3.69-3.72 and rec 6, that all securities be excluded from the definition of derivative. The interaction of the futures contracts and securities definitions in the then Corporations Law was considered in *Sydney Futures Exchange Ltd v Australian Stock Exchange Ltd* (1995) 16 ACSR 148 (the LEPO case). A useful analysis of the interaction of the regulation of securities and futures prior to the introduction of the current Chapter 7 is provided in B Saunders, 'Has the Financial Services Reform Act fixed the problems with the regulation of securities and derivatives?' (2010) 21 *Journal of Banking and Finance Law and Practice* 33 at 34-37.

The licensing and disclosure obligations for various persons who deal in, or provide advice on, any form of financial product, including derivatives, are outlined in Section 3.2.

The specific regulatory provisions for derivatives are set out in Section 3.3.

Some of the key comparisons between securities and derivatives are outlined in Section 3.4.

In addition to the legislative provisions, on-exchange derivatives transactions, and the role of brokers in those transactions, are subject to the listing and operating rules of the relevant market.

3.2 Licensing and disclosure requirements for financial products

3.2.1 Licensing requirement

Subject to various stated exemptions, anyone who carries on a financial services business must have an Australian financial services licence.[39] The key concepts are:

- ‘carries on’ and
- ‘financial services business’.

Carries on. There are various provisions that affect the meaning of when a person is carrying on a financial services business.[40]

Financial services business. A financial services business is defined as ‘a business of providing financial services’.[41] There are various tests of when ‘a person provides a financial service’,[42] including if the person ‘deals’ in a financial product.[43] The issue by a body (other than a body carrying on an investment business involving the investment of funds subscribed by the public for that purpose[44]) of

39 s 911A.
40 s 761C, which refers to Part 1.2 Div 3.
41 s 761A.
42 s 766A.
43 s 766A(1)(b). ‘Dealing’ is defined in s 766C.
44 s 766C(5).

its own securities[45] is deemed not to be a dealing in a financial product[46] and accordingly a licence is not required for this activity. There is no equivalent exemption for a body that issues its own derivatives. A person who issues derivatives in the course of conducting a financial services business is 'dealing' in financial products[47] and requires a financial services licence.[48]

Authorisation of services

A licence must specify the particular financial services, or class of financial services, for which the licensee is authorised.[49] This specification may be made by reference to particular financial products or classes of financial products.[50]

There are specific financial requirements for a person holding an authorisation to deal in derivatives, which are different from the financial requirements for those involved with other financial products.[51] These requirements recognise the exposure of the licensee to counterparties arising from entering into OTC derivatives.

Consequences of unlicensed dealing

If a person deals in financial products without a licence:

- the clients of that person can rescind any agreements in relation to that product[52]
- those agreements will be unenforceable against the clients.[53]

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45 Options issued by a company over its unissued shares are securities: see paragraph (d) of the definition of 'security' in s 761A.
46 s 766C(4).
47 s 766C(1)(b).
48 s 911A.
49 s 914A(6).
50 s 914A(7).
51 See, for instance, ASIC Consultation Paper 156 *Retail OTC derivative issuers: Financial requirements*.
52 s 925A.
53 s 925E.

3.2.2 General obligations on a financial services licensee

A financial services licensee has a range of general obligations, including to:

- do all things necessary to ensure that the financial services covered by the licence are provided efficiently, honestly and fairly[54]
- have adequate arrangements for managing conflicts of interest[55]
- comply with the conditions on the licence[56]
- comply with the financial services laws[57]
- take reasonable steps to ensure that its representatives comply with the financial services laws[58]
- unless the licensee is regulated by APRA, have adequate financial, technological and human resources to provide the financial services covered by the licence and to carry out supervisory arrangements[59]
- maintain the competence to provide the financial services covered by the licence[60]
- ensure that its representatives are adequately trained, and are competent, to provide those financial services[61]
- if providing financial services to retail clients, have a dispute resolution system[62] and appropriate arrangements to compensate

54 s 912A(1)(a).
55 s 912A(1)(aa). See further *ASIC v Citigroup Global Markets Australia Pty Ltd (No 4)* [2007] FCA 963.
56 s 912A(1)(b).
57 s 912A(1)(c).
58 s 912A(1)(ca).
59 s 912A(1)(d).
60 s 912A(1)(e).
61 s 912A(1)(f).
62 s 912A(1)(g).

retail clients who have suffered loss or damage through breaches of relevant obligations[63]

- unless regulated by APRA, establish and maintain adequate risk management systems.[64]

3.2.3 Conduct obligations on a licensee

Licensees have various conduct obligations under Parts 7.6, 7.8, 7.9 and 7.10 of the Corporations Act, including to:

- notify ASIC of breaches or likely breaches of certain significant licensee obligations[65]
- assist ASIC in its regulatory supervision of the licensee[66]
- quote their Australian financial services licence number in documents[67]
- comply with certain procedures when dealing with clients' money and other property[68]
- keep financial records and prepare and lodge financial statements.[69]

3.2.4 Disclosure obligations on a licensee

There are specific disclosure requirements for all financial products offered to retail clients.[70] These include providing a financial services guide to people proposing to obtain financial services from the relevant person. When some types of advice are provided to a retail client, there is a requirement to provide a statement of advice to that client.[71]

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63 s 912B, Corp Reg 7.6.02AAA.
64 s 912A(1)(h).
65 s 912D.
66 s 912E.
67 s 912F.
68 Part 7.8 Divs 2, 3. See further Treasury discussion paper *Handling and use of client money in relation to over-the-counter derivatives transactions* (November 2011).
69 Part 7.8 Div 6.
70 Part 7.7.
71 Part 7.7 Div 3.

There is also a specific requirement to provide a retail client with a product disclosure statement before the product is issued or acquired by the retail client.

3.2.5 Product Disclosure Statement

A person who advises on a financial product,[72] issues a financial product[73] or offers a financial product for sale[74] to a retail client must meet the Product Disclosure Statement obligations[75] or face criminal sanctions[76] and civil remedies.[77] The latter include an action to recover the amount of loss or damage suffered[78] or to have the relevant contract declared void.[79]

3.2.6 Financial Services Guide and Statement of Advice

A 'providing entity'[80] will be subject to the obligations concerning the provision of a Financial Services Guide and a Statement of Advice,[81] which are subject to criminal sanctions[82] and civil remedies[83] in the event of breach.

3.3 Specific provisions applying to derivatives

In addition to the licensing and disclosure requirements that apply to all financial products, including derivatives (see Section 3.2), various provisions in the Corporations Act and Corporations Regulations specifically apply to derivatives.[84]

72 s 1012A.
73 s 1012B. This was the ground relied on in *Keynes v Rural Directions Pty Ltd (No 2)* [2009] FCA 567: see at [15], [24], [57]-[58], [100].
74 s 1012C.
75 Part 7.9 Div 2 Subdiv C.
76 Part 7.9 Div 7 Subdiv A.
77 Part 7.9 Div 7 Subdiv B.
78 s 1022B.
79 s 1022C.
80 s 940B(1)(a).
81 Part 7.7.
82 Part 7.7 Div 7 Subdiv A.
83 Part 7.7 Div 7 Subdiv B.
84 CAMAC acknowledges the work of Alan Worsley of ASIC in the preparation of these tables.

3.3.1 Outline of the provisions

Part 7.1 and Part 7.6—Definition of financial product and financial service

Section or regulation	Effect	Implications
s 761B	Two or more component arrangements may, when viewed together, be a derivative	Arrangements that by themselves do not constitute a derivative may be considered to be a derivative when the arrangements are collectively considered.
s 761E(3)	Identifies who issues a derivative	A person is an issuer of a derivative when the person enters into the legal relationship that constitutes the derivative.
s 761E(5)	Identifies who issues a derivative that is not traded on a financial market	Each person who is a party to a derivative not entered into or acquired on a 'financial market' is an issuer of the financial product.
s 761E(6)	Identifies the issuer of a derivative traded on a financial market	The issuer will be a financial services licensee who enters into the arrangement, or whose authorised representative enters into the arrangement, on behalf of any person. If there is no financial services licensee then the issuer of the derivative will be the market operator.
Reg 1.0.02	Definition of non-cash payment financial product	Definition of NCP excludes derivatives.
Reg 7.1.09(c)	A clearing and settlement facility may involve obligations arising under a derivative	Derivatives may be cleared through a licensed clearing and settlement facility.
Reg 7.1.22	Method of valuing derivatives	Prescribes the method for determining the value of derivatives, applying the retail wholesale test for the purpose of s 761G. The test must be used for those financial products that are derivatives.
Reg 7.1.22A	Method of valuing foreign exchange contracts that are not derivatives	Need to determine whether the financial product is a derivative or a foreign exchange contract to determine which valuation method to use.

Section or regulation	Effect	Implications
Reg 7.1.40	Exclusion from definition of custodial and depository services for market participants holding derivatives in certain circumstances	A participant in a licensed clearing and settlement facility that holds a derivative registered on the licensed clearing and settlement facility by the provider on behalf of the client will not be operating a custodial or depository service. Participants in licensed markets trading derivatives are also excluded from the definition of custody and depository services.
Reg 7.6.01	People involved with some types of derivatives that are dealing in the derivative for what are in effect hedging purposes are not required to hold an Australian financial services licence. The exclusion applies where certain conditions are met, including that the dealing in derivatives is not a significant part of the person's business and the dealing is entered into on the person's own behalf.	This exemption is significant as it means that those entering into derivatives within the scope of the exemption are not required to hold an Australian financial services licence.

Part 1.2—Interpretation

Section or regulation	Effect	Implications
s 9	Incorporates definition of derivative from Chapter 7 for the rest of the Corporations Act	Omnibus definition of derivative for the Corporations Act

Part 5D—Trustee Companies

Section or regulation	Effect	Implications
Reg 5D.2.06(4)	Limits dealing in derivatives associated with a common fund	A derivative must be entered into for the purpose of managing a financial risk associated with the common fund and must comply with the trustee company's equitable and other duties in relevant State legislation.

Part 7.2—Licensing of financial markets

Section or regulation	Effect	Implications
Reg 7.2.07	The operating rules of a licensed financial market on which derivatives are traded must contain details of the derivative contracts that are being traded on the market	The terms of the derivative traded on a financial market must be set out in the rules of that market. The regulations do not require that the operating rules contain similar details about other financial products.

Part 7.7—Financial Services Disclosure

Section or regulation	Effect	Implications
s 923B(3)(b)	ASIC may impose a condition authorising a person to use the term ‘futures broker’ if the person provides a financial service relating to derivatives	Only those dealing in derivatives may call themselves a futures broker.
s 946B(1)(c)	Restricted disclosure is permitted when providing advice about derivatives that are able to be traded on a licensed financial market.	Statements of advice are not required for dealing in some exchange-traded derivatives. This exclusion also applies to exchange-traded securities and managed investments.
s 981D	Client money being held for trading in derivatives may be used for the purpose of meeting obligations incurred by an Australian financial services licensee for margining, guaranteeing, securing, transferring, adjusting or settling dealing in derivatives by the licensee	When the relevant financial product is a derivative, the client money may be applied for dealings by the licensee associated with the trading in derivatives.
s 984B(2)	Client property may also be used for the purpose of meeting obligations incurred by an Australian financial services licensee for margining, guaranteeing, securing, transferring, adjusting or settling dealing in derivatives by the licensee	When the relevant financial product is a derivative, the client property may be applied for dealings by the licensee associated with the trading in derivatives.
s 986B	Regulations may impose reporting requirements on Australian financial services licensees dealing in derivatives on behalf of other people	Scope for specialised regulation of reporting obligations when derivatives are being dealt in.

Section or regulation	Effect	Implications
Reg 7.7.02(5B)	Financial Services Guides (FSGs) are not required for some types of derivatives	FSGs will not be required where: • the provider is an issuer of derivatives that are able to be traded on a financial market • the financial service is a dealing in a derivative by the provider • at the time of dealing, the provider is not a participant in the financial market on which the particular derivative may be traded • the only financial service being provided to the client is the issuing of the derivative

Part 7.8—Conduct of business rules

Section or regulation	Effect	Implications
Reg 7.8.21	A person who is an employee of a person holding an Australian financial services licence who is not a participant of the licensed market on which derivatives are traded may trade those derivatives on the relevant market through another licensee.	Employees can deal in a derivative through a licensee other than the person's employer, where the derivative gets its value from another financial product that the person's employer cannot trade on a financial market. The employee is permitted to trade through another licensee where the person's employer is not a participant in that financial market for those financial products.

Part 7.9—Product disclosure

Section or regulation	Effect	Implications
Reg 7.9.07B	Product disclosure statements (PDSs) for market-traded derivatives	Modified disclosure requirements will only apply to derivatives where the terms and conditions of the derivative are specified by the market operator and are made generally available to the public. The Australian financial services licensee must also be the issuer of the derivative and a retail client must have agreed to the terms and conditions that apply to the financial product. Information specific to the type of derivative must be provided about its exercise prices, expiry dates and exercise styles. Some information about the derivative need not be disclosed in the PDS, including: • information about the derivative that is available from other material provided by the market operator • information that is generally made available to the public by the market operator.
Reg 7.9.07C	No right to return defective derivatives and obtain a refund for some types of exchange-traded derivatives	No return or refund for market-traded derivatives where the operating rules of either the financial market or the clearing and settlement facility permit the closing out of the derivatives by matching with offsetting positions.
Reg 7.9.37	Fund information for superannuation funds and ADFs	Provide details and an explanation of the derivatives charge ratio of the fund
Reg 7.9.63A	Confirmations are required for most derivative transactions	A transaction that is not the issue of a financial product (other than a derivative that is not a warrant) and in which a financial services licensee deals in the financial product on behalf of the holder of the financial product and that results in the holder acquiring or disposing of a financial product must be confirmed by the financial services licensee

Section or regulation	Effect	Implications
Reg 7.9.80B	Some derivatives may not be short sold	A derivative that is transferable is not able to be short sold.

Part 7.10—Market misconduct and other prohibited conduct

Section or regulation	Effect	Implications
s 1042A	Insider trading provisions apply to derivatives	Insider trading provisions apply also to other financial products: • securities • interests in managed investment schemes • debentures, stocks or bonds that are government issued • superannuation products • any other financial products that are able to be traded on a financial market.
s 1043L	Details when compensation orders for damages may be made, but does not apply to derivatives	Derivatives will not be subject to s1043L.

ASIC Act

Section or regulation	Effect	Implications
s 12BAA(7)	Provides that a derivative is subject to the unconscionable conduct and consumer protection provisions in the Corporations Act.	Express provision to ensure that derivatives are subject to consumer protection provisions of the Corporations Act.
s 12BAB(17), Reg 45	Defines clearing and settlement facility for the purposes of the consumer protection provisions of the ASIC Act	Adopts the same definition of clearing and settlement facility as used in the Corporations Act.
s 73(1)(h)	Confers power on ASIC to make a range of orders, including an order requiring a specified person to dispose of specified derivatives, or to dispose of specified derivatives in a specified manner	ASIC can make orders about a range of financial products, including derivatives.

Section or regulation	Effect	Implications
s 73(2)	Orders made under s 73 do not affect closing out of contracts or registration of derivatives	The operator of a relevant financial market and a clearing and settlement facility can continue to take the ordinary steps of processing a transaction when an order is made under s 73.

3.3.2 ASIC Relief for derivatives

ASIC has power to issue relief and to vary parts of the Corporations Act, including those relating to the licensing of providers of financial services,[85] financial services disclosure,[86] financial products disclosure[87] and other provisions relating to conduct connected with financial products and financial services.[88]

ASIC has issued a number of Class Orders that apply to derivatives, for example CO 06/682 *Multiple derivative issuers* and CO 04/1431 *Dollar Disclosure: Costs of derivatives, foreign exchange contracts, general insurance products and life risk insurance products.*[89]

The Class Orders may vary obligations that arise under the Corporations Act in relation to derivatives.

3.4 Comparison of the regulation of derivatives and securities

There can be close functional similarities between securities and some derivatives, the most obvious being equity derivatives, used for both trading and risk management purposes. Some of the implications of this overlap are considered, for instance, in Takeovers Panel Guidance Note 20 *Equity Derivatives.*

There are similarities and differences between the regulation of derivatives and that of securities:

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85 s 926A.
86 s 951B.
87 s 1020F.
88 s 992B.
89 These Class Orders were made pursuant to s 1020F.

> The *Corporations Act* … treats derivatives and securities as functionally equivalent for some purposes but not for others. In some cases, securities are regulated more stringently, however in other cases, derivatives are subject to higher levels of regulation.[90]

In addition to licensing and disclosure requirements applicable to all financial products (see Section 3.2), other provisions apply specifically to either securities or derivatives. In this context, comparisons can be drawn between the regulation of securities and that of derivatives, including in relation to:

- advertising
- disclosure relating to issuing securities/derivatives
- continuous disclosure
- market misconduct
- hawking.

3.4.1 Advertising

The controls on advertising securities are more stringent than for derivatives. For instance, prior to issue of the relevant disclosure document (see Section 3.4.2), limited advertising of securities is permitted, in the form of a 'tombstone statement' setting out some minimal information.[91] More general advertising of derivatives before the issue of the relevant disclosure document (see Section 3.4.2) is permissible, provided that the advertisement includes information foreshadowing the disclosure document.[92]

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90 B Saunders, 'Has the Financial Services Reform Act fixed the problems with the regulation of securities and derivatives?' (2010) 21 *Journal of Banking and Finance Law and Practice* 33 at 51. This article outlines in detail the differences between the regulation of securities and derivatives, including through a series of comparative tables. Some of these differences are summarised in Sections 3.4.1-3.4.5 of this report.

91 s 734(5).

92 s 1018A(2).

3.4.2 Disclosure related to issuing securities/derivatives

There are separate disclosure requirements for the issue of securities through a prospectus[93] and the issue of derivatives through a product disclosure statement (PDS).[94]

The general tests for information disclosure differ between a prospectus and a PDS. For instance, a prospectus for a securities issue must contain information 'only to the extent to which it is reasonable for investors and their professional advisers to expect to find the information in the prospectus'.[95] By comparison, a PDS related to the issue of derivatives does not require the disclosure of particular information 'if it would not be reasonable for a person considering, as a retail client, whether to acquire the product to expect to find the information in the [PDS]'.[96]

The requirements for a prospectus are in some respects more exacting than those for a PDS. For instance, the issue of securities through a prospectus is subject to a 'due diligence' requirement for the inclusion in the prospectus of information that the person whose knowledge is relevant 'ought reasonably to have obtained … by making enquiries',[97] whereas the issue of derivatives only requires the disclosure in the PDS of information 'actually known' to the issuer or other relevant person.[98]

3.4.3 Continuous disclosure

The continuous disclosure regime in Chapter 6CA applies to information that would be reasonably expected to have a material effect on the price or value of securities of a disclosing entity.[99] These provisions do not apply to derivatives.

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93 Chapter 6D.
94 Part 7.9 Div 2.
95 s 710(1)(a).
96 s 1013F(1). Subsection 1013F(2) sets out various factors to be considered for the purpose of s 1013F(1).
97 s 710(1)(b)(ii).
98 s 1013C(2).
99 ss 674(2)(c)(ii); 111AC, 111AD.

3.4.4 Market misconduct

For the most part, the same approach to market misconduct is adopted for securities and for derivatives. The market misconduct (including market manipulation, false trading and market rigging), and insider trading, provisions in Part 7.10 apply to 'financial products' generally, including both securities and derivatives. However, compensation orders for insider trading do not apply to derivatives.[100]

The short selling provisions[101] apply to securities[102] and derivatives.[103]

The CAMAC report *Insider Trading* (2003) proposed, in effect, that most OTC derivatives be exempt from the insider trading provisions.[104] This recommendation has not been adopted.

3.4.5 Hawking

Hawking of securities[105] is regulated separately from hawking of other financial products, including derivatives.[106]

There are some basic similarities. For instance, neither securities nor derivatives may be offered for issue or sale as a result of an unsolicited meeting.[107] However, there are also some material differences between these provisions.

The prohibition on securities hawking is less stringent in some respects than the prohibition on derivatives hawking. For instance, some exceptions from the prohibition apply to unsolicited offers of securities,[108] but not to unsolicited offers of derivatives.

In other respects, the prohibition on securities hawking is the more stringent. For instance, securities cannot be offered through

100 s 1043L.
101 s 1020B.
102 s 1020B(1)(a).
103 s 1020B(1)(d) and Corp Reg 7.9.80B.
104 Section 4.7 and rec 38.
105 s 736.
106 s 992A.
107 ss 736(1), 992A(1).
108 s 736(2).

unsolicited telephone calls,[109] whereas derivatives can be so offered provided certain requirements are met.[110] Also, the prohibition on securities hawking is a strict liability offence,[111] whereas the hawking of derivatives is not.

3.5 CAMAC comments

CAMAC considers that the Australian on-exchange and OTC derivatives markets are appropriately regulated through a framework of licensing and disclosure requirements applicable to all financial products, including derivatives, as well as provisions specifically tailored for derivatives. Regulatory issues within this legislative framework, principally directed at OTC derivatives markets and products, are discussed in chapter 2.

CAMAC notes that the current regulatory framework follows the approach in the CASAC report that, if a financial product that is covered by the definition of derivative also falls within one of the other categories of financial product, such as a security, it is treated as the other type of financial product, not as a derivative. CAMAC considers that financial market participants have become accustomed to this arrangement, which avoids double regulation, and which should not be changed in the absence of clear and significant problems having arisen.

There is debate about the introduction of a 'substantive' test for composite financial products. Under one approach, a financial product that satisfies the derivative definition and could also be some other form of financial product, such as a security, would be regulated as a derivative if it is substantively, rather than incidentally, a derivative. CAMAC is concerned about the means of distinguishing between a substantive and an incidental derivative. Without an applicable 'bright line' test, or the need for greater resort to the regulation-making powers in s 761D to declare something to be or not to be a derivative, there could be considerable regulatory and market uncertainty over the classification of particular financial products.

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109 s 736(1)(b).
110 s 992A(3).
111 s 736(1B).

CAMAC's consultations have not revealed any substantial regulatory arbitrage or investor protection problems arising from the current system for classifying financial products.

CAMAC considers that some of the differences identified in this report between the regulation of derivatives and that of securities could, at an appropriate time, be rationalised. However, there do not appear to be any fundamental difficulties in this regulatory framework that call for immediate rectification.

4 Definition of derivative

This chapter reviews the elements of the definition of derivative in s 761D of the Corporations Act and compares that provision with approaches to the definition of derivative adopted in various other jurisdictions.

4.1 Current definition: general approach

4.1.1 Corporations Act

The definition of derivative in s 761D is based on the recommendation in the CASAC report that there be a broad-ranging definition that seeks to cover all possible derivatives, with a series of exceptions to that definition.[112]

The CASAC report explained that:

> This broad-ranging approach is intended to accommodate innovative derivatives products without creating any regulatory gaps or the need for amendments to the derivatives definition as new classes of derivatives arise.[113]

There are in fact two definitions of 'derivative', one in s 761D(1) of the Corporations Act (the Corporations Act definition) and the other in Corp Reg 7.1.04(2) (the Corporations Regulations definition).[114]

Under both definitions, a derivative is an arrangement[115] that has:

- a future liability element[116]

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112 rec 4 and the accompanying discussion at paras 3.33-3.65.
113 para 3.35.
114 The definition in Corp Reg 7.1.04(2) is enacted pursuant to s 761D(2), which provides that 'anything declared by the regulations to be a derivative for the purposes of this section is a derivative for the purposes of this Chapter'.
115 This is defined widely in s 761A to include a contract, agreement, understanding, scheme or other arrangement, whether formal or informal, or partly formal and partly informal, whether written or oral, or partly written and partly oral and whether or not enforceable, or intended to be enforceable, by legal proceedings and whether or not based on legal or equitable rights.

- a derived value element.

The definition in Corp Reg 7.1.04(2) largely mirrors that in s 761D(1), but differs in relation to one aspect of the future liability element, as explained in Section 4.2 of this report.

The CASAC report recognised that, to avoid the generic definition of derivative being over-regulatory, it was necessary to stipulate various classes of agreements that were not to be regarded as derivatives under that definition.[117] In consequence, the legislation provides that derivatives do not include:

- arrangements for mandatory physical delivery of tangible property[118]
- a contract for the future provision of services[119]
- anything that falls within one of the other categories of financial product[120]
- anything that might, in the absence of an exception, be taken to be a derivative merely because the arrangement provides for the consideration to be varied by reference to a general inflation index such as the Consumer Price Index[121]
- anything declared by the regulations not to be a derivative for the purposes of Chapter 7.[122]

The definition also provides for regulations to declare something to be a derivative.[123]

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116 As explained by one commentator:

> A fundamental element of derivative contracts is that they have an extended lifespan so that the value of the contract can vary during the life of the contract….This varying value of the contract is then used by parties to either gain speculative profit from the contract or to hedge against potential losses… (J Chellew, 'The FSR Act's derivative definition: Cleaning up the intraday contract problem' (2005) 16 *Journal of Banking and Finance Law and Practice* 114 at 115).

117 Section 3.36.

118 s 761D(3)(a), Corp Reg 7.1.04(4).

119 s 761D(3)(b), Corp Reg 7.1.04(6).

120 s 761D(3)(c), Corp Reg 7.1.04(7).

121 s 761D(4), Corp Reg 7.1.04(5).

122 s 761D(3)(d).

The elements of s 761D, including recent case law on their interpretation and application, are further discussed in Sections 4.2–4.4 of this report.

As one judge has said:

> The definition of "derivative" is extraordinarily wide, one which could catch many arrangements not ordinarily thought of as derivatives. ... Given this deliberate drafting, there is little warrant for reading down the definition in the inclusory s 761D(1). It was intended to be wide; over-width was to be controlled by the subsequent exclusions, including by regulation.[124]

4.1.2 Accounting standards

The definition of derivative in AASB 139 *Financial Instruments: Recognition and Measurement*, which applies to the preparation of financial information, is:

> A derivative is a financial instrument or other contract within the scope of this Standard (see paragraphs 2–7) with all three of the following characteristics:
>
> (a) its value changes in response to the change in a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index, or other variable, provided in the case of a non-financial variable that the variable is not specific to a party to the contract (sometimes called the 'underlying');
>
> (b) it requires no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors; and
>
> (c) it is settled at a future date.

Proposed International Financial Reporting Standard (IFRS) 9 *Financial Instruments* (which is to replace *IAS 39 Financial Instruments: Recognition and Measurement*) deals with the

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[123] s 761D(2).
[124] Giles JA in *International Litigation Partners Pte Ltd v Chameleon Mining NL* [2011] NSWCA 50 at [66], [72].

classification and measurement of financial assets, including derivatives.[125]

4.1.3 Definition of derivative in various other jurisdictions

Various ways of describing or defining derivatives have been employed in overseas jurisdictions, including in New Zealand, the UK and the USA.

New Zealand

The New Zealand *Financial Markets Conduct Bill* (2011) adopts the same definition of derivative as in s 761D of the Corporations Act, except that it includes an additional subparagraph in the equivalent of s 761D(1), namely, that, in addition to the general definition, a derivative:

> b. includes a transaction that is currently, or in the future becomes, recurrently entered into in the financial markets and is commonly referred to in those markets as -
>
> i. a futures agreement or forward; or
>
> ii. an option (other than an option to acquire an equity security, a debt security, or a managed investment product by way of issue); or
>
> iii. a swap agreement; or
>
> iv. a contract for difference; or
>
> v. a cap, collar, floor, or spread.

The additional subparagraph (b) was not proposed in the June 2010 discussion paper leading up to the Bill, but strong industry demand emerged in the subsequent consultation process for the definition of derivative to include such a list. The rationale is that:

- a list of specific inclusions makes the definition clearer and more accessible to market participants, particularly overseas participants

[125] The International Accounting Standards Board may postpone the mandatory effective date of IFRS 9 *Financial Instruments* from 1 January 2013 to 1 January 2015.

- the list removes doubt about whether various kinds of derivatives fall within the definition
- the list helps to resolve certain boundary issues in New Zealand, for instance between the definition of ‘debt security’ and the definition of ‘derivative’. There were particular concerns that, for example, interest rate swaps might fall within the definition of ‘debt security’ (that is, ‘a right to be repaid money or paid interest on money that is, or is to be, deposited with, lent to, or otherwise owing by, any person’). To resolve this, the definition of debt security elsewhere in the draft Bill excludes any of the financial instruments in paragraph (b) of the definition of derivative.

The Bill also proposes enhanced powers for the New Zealand regulator (the Financial Markets Authority) in regard to the classification of financial products, including derivatives (see Section 4.5 of this report).

The Bill was introduced into the New Zealand Parliament in October 2011.

United Kingdom

The Financial Services Authority Handbook defines ‘derivative’ as a *contract for differences*, a *future* or an *option*:

> *contract for differences*
>
> the investment, specified in article 85 of the *Regulated Activities Order* (Contracts for differences etc), which is in summary rights under:
>
> (a) a contract for differences; or
>
> (b) any other contract the purpose or pretended purpose of which is to secure a profit or avoid a loss by reference to fluctuations in:
>
> (i) the value or price of property of any description; or
>
> (ii) an index or other factor designated for that purpose in the contract; or
>
> (c) a derivative instrument for the transfer of credit risk to which article 85(3) of the *Regulated Activities Order* applies.

future

the investment specified in article 84 of the *Regulated Activities Order* (Futures), which is in summary: rights under a contract for the sale of a commodity or property of any other description under which delivery is to be made at a future date and at a price agreed on when the contract is made.

option

the investment specified in article 83 of the *Regulated Activities Order* (Options), which is an option to acquire or dispose of:

(a) a designated investment (other than an option or one to which (d) or (e) applies); or

(b) currency of the United Kingdom or of any other country or territory; or

(c) palladium, platinum, gold or silver; or

(d) a commodity to which article 83(2) of the *Regulated Activities Order* applies; or

(e) a financial instrument in paragraph 10 of Section C of Annex 1 to MiFID to which article 83(3) of the *Regulated Activities Order* applies; or

(f) an option to acquire or dispose of an option specified in (a), (b) (c), (d) or (e),

but so that for the purposes of calculating capital requirements for BIPRU firms and BIPRU 10 (Large exposures requirements) it also includes any of the items listed in the table in BIPRU 7.6.18 R (Option PRR: methods for different types of option) and any cash settled option.

The *Regulated Activities Order* contains a series of exclusions from the scope of the concept of regulated activity, including various risk management exclusions.

The Handbook defines ‘securities derivative’ as:

a derivative instrument admitted to trading on a regulated market or prescribed market, the value of which is dependent on an underlying equity or debt instrument or index/basket of equity or debt instruments.

United States

Section 721 of the Dodd-Frank Act inserts a new definition of a 'swap' in the Commodities Exchange Act. Swaps are financial instruments that fall under the general umbrella of financial derivatives. In essence, a swap is an agreement between two parties to exchange a series of future cash flows. The extended definition is as follows:

> *Swap*
>
> *(A) IN GENERAL.*—Except as provided in subparagraph (B), the term 'swap' means any agreement, contract, or transaction—
>
> > (i) that is a put, call, cap, floor, collar, or similar option of any kind that is for the purchase or sale, or based on the value, of one or more interest or other rates, currencies, commodities, securities, instruments of indebtedness, indices, quantitative measures, or other financial or economic interests or property of any kind;
> >
> > (ii) that provides for any purchase, sale, payment, or delivery (other than a dividend on an equity security) that is dependent on the occurrence, non-occurrence, or the extent of the occurrence of an event or contingency associated with a potential financial, economic, or commercial consequence;
> >
> > (iii) that provides on an executory basis for the exchange, on a fixed or contingent basis, of 1 or more payments based on the value or level of 1 or more interest or other rates, currencies, commodities, securities, instruments of indebtedness, indices, quantitative measures, or other financial or economic interests or property of any kind, or any interest therein or based on the value thereof, and that transfers, as between the parties to the transaction, in whole or in part, the financial risk associated with a future change in any such value or level without also conveying a current or future direct or indirect ownership interest in an asset (including any enterprise or investment pool) or liability that incorporates the financial risk so transferred, including any agreement, contract, or transaction commonly known as—
> >
> > > (I) an interest rate swap;
> > > (II) a rate floor;
> > > (III) a rate cap;

(IV) a rate collar;
(V) a cross-currency rate swap;
(VI) a basis swap;
(VII) a currency swap;
(VIII) a foreign exchange swap;
(IX) a total return swap;
(X) an equity index swap;
(XI) an equity swap;
(XII) a debt index swap;
(XIII) a debt swap;
(XIV) a credit spread;
(XV) a credit default swap;
(XVI) a credit swap;
(XVII) a weather swap;
(XVIII) an energy swap;
(XIX) a metal swap;
(XX) an agricultural swap;
(XXI) an emissions swap; and
(XXII) a commodity swap;

(iv) that is an agreement, contract, or transaction that is, or in the future becomes, commonly known to the trade as a swap;

(v) including any security-based swap agreement which meets the definition of ‘swap agreement’ as defined in section 206A of the Gramm-Leach-Bliley Act of which a material term is based on the price, yield, value, or volatility of any security or any group or index of securities, or any interest therein; or

(vi) that is any combination or permutation of, or option on, any agreement, contract, or transaction described in any of clauses (i) through (v).

(B) EXCLUSIONS.—The term ‘swap’ does not include—

(i) any contract of sale of a commodity for future delivery (or option on such a contract), leverage contract authorized under section 19, security futures product, or agreement, contract, or transaction described in section 2(c)(2)(C)(i) or section 2(c)(2)(D)(i);

(ii) any sale of a nonfinancial commodity or security for deferred shipment or delivery, so long as the transaction is intended to be physically settled;

(iii) any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities, including any interest therein or based on the value thereof, that is subject to—

(I) the Securities Act of 1933 and

(II) the Securities Exchange Act of 1934

(iv) any put, call, straddle, option, or privilege relating to a foreign currency entered into on a national securities exchange registered pursuant to section 6(a) of the Securities Exchange Act of 1934 (15 U.S.C. 78f(a));

(v) any agreement, contract, or transaction providing for the purchase or sale of 1 or more securities on a fixed basis that is subject to—

(I) the Securities Act of 1933 and

(II) the Securities Exchange Act of 1934

(vi) any agreement, contract, or transaction providing for the purchase or sale of 1 or more securities on a contingent basis that is subject to the Securities Act of 1933 and the Securities Exchange Act of 1934 unless the agreement, contract, or transaction predicates the purchase or sale on the occurrence of a bona fide contingency that might reasonably be expected to affect or be affected by the creditworthiness of a party other than a party to the agreement, contract, or transaction;

(vii) any note, bond, or evidence of indebtedness that is a security, as defined in section 2(a)(1) of the Securities Act of 1933

(viii) any agreement, contract, or transaction that is—

(I) based on a security; and

(II) entered into directly or through an underwriter (as defined in section 2(a)(11) of the Securities Act of 1933 by the issuer of such security for the purposes of raising capital, unless the agreement, contract, or transaction is entered into to manage a risk associated with capital raising;

(ix) any agreement, contract, or transaction a counterparty of which is a Federal Reserve bank, the Federal Government, or a Federal agency that is

> expressly backed by the full faith and credit of the United States; and
>
> (x) any security-based swap, other than a security-based swap as described in subparagraph (D).

4.2 Future liability and derived value elements

4.2.1 The future liability element

The future liability element in s 761D(1) has two components:

> (a) under the arrangement, a party to the arrangement must, or may be required to, provide at some future time consideration of a particular kind or kinds to someone; and
>
> (b) that future time is not less than the number of days, prescribed by regulations made for the purposes of this paragraph, after the day on which the arrangement is entered into.[126]

In relation to the expression 'may be required', Giles JA in *International Litigation Partners Pte Ltd v Chameleon Mining NL* [2011] NSWCA 50 observed:

> An arrangement may call for a party to provide consideration of more than one kind, depending on future events, one of which is affected by the value or amount of something else and another of which is not. The party "may be required" to provide the consideration of the former kind, if the appropriate future events occur, but this will not necessarily be so. It will be sufficient if the amount of that consideration is affected by the value or amount of something else; and if it is, the value of the arrangement will be affected by the value or amount of the something else. It does not matter that in other future events the consideration which is not affected by the value or amount of something else is the consideration which must be provided.[127]

He added that:

> any other reading of the definition would permit it be avoided by the simple expedient of providing for payment of

---

[126] s 761D(1)(a), (b).
[127] at [56].

> a fixed $1, no matter what happened in relation to the something else and its effect on the amount of the substantive consideration.[128]

For foreign exchange contracts, the future time must be not less than 3 business days after the day on which the arrangement is entered into. The applicable definition for foreign exchange contracts is the Corporations Act definition:[129] the Corporations Regulations definition does not apply.[130]

In any other case, Corp Reg 7.1.04(2) extends the definition of derivative to intra-day transactions.[131] It provides that the future time in a case other than a foreign exchange contract 'may be less than 1 day after the arrangement is entered into'.[132] Subsection 761D(1) covers transactions where the future time is not less than 1 business day after the day on which the arrangement is entered into.[133]

It has been argued that the exclusion of intra-day contracts from the Corporations Act definition is misleading, given their inclusion in the Corporations Regulations definition.[134] The court in one case, relying on the Corporations Act definition, seemed to assume that intra-day contracts were not derivatives.[135]

4.2.2 The derived value element

Under the derived value element in s 761D(1)(c):

> the amount of the consideration, or the value of the arrangement, is ultimately determined, derived from or varies by reference to (wholly or in part) the value or amount

128 at [57].
129 s 761D(1)(b), Corp Reg 7.1.04(1)(a).
130 Corp Reg 7.1.04(2)(a).
131 Corp Reg 7.1.04(2) is itself a definition of derivative, as it applies pursuant to s 761D(2), which provides that the regulations may declare anything to be a derivative.
132 Corp Reg 7.1.04(2)(b).
133 In the Corporations Act definition, the future time is not less than a number of days prescribed in the regulations (s 761D(1)(b)). The regulations prescribe 1 business day for cases other than foreign exchange contracts (Corp Reg 7.1.04(1)(b)).
134 J Chellew, 'The FSR Act's derivative definition: Cleaning up the intraday contract problem' (2005) *16 Journal of Banking and Finance Law and Practice* 114.
135 *Keynes v Rural Directions Pty Ltd (No 2)* [2009] FCA 567 at [87] refers to the '1 business day' prescribed period in Corp Reg 7.1.04(1)(b), but does not refer to the provision in Corp Reg 7.1.04(2)(b), under which the future time 'may be less than 1 day'.

> of something else (of any nature whatsoever and whether or not deliverable), including, for example, one or more of the following:
>
> (i) an asset;
>
> (ii) a rate (including an interest rate or exchange rate);
>
> (iii) an index;
>
> (iv) a commodity.

Forward contracts

The derived value element appears to have given rise to the doubt referred to in the PST's terms of reference to CAMAC about whether physically settled forward contracts over shares are derivatives.

A forward contract involves an obligation on one party to buy, and an obligation on the other to sell, an underlying asset at a specific price and date in the future.[136]

The position in relation to forward contracts for mandatory physical settlement of tangible property is clear: those contracts are covered by an exception to the definition of derivative and are therefore not derivatives (see Section 4.3 of this report).

However, there has been some judicial uncertainty about how the derived value element would apply in the absence of an exception. This is relevant to the application of the definition of derivative to forward contracts over securities. In *Keynes v Rural Directions Pty Ltd (No 2)* [2009] FCA 567, the plaintiff sought to avoid an obligation it had incurred under forward contracts for the supply of wheat and barley, arguing that the contracts were derivatives under s 761D and it had not received a product disclosure statement from the counterparty. It was put to the Court that:

> if the price of wheat or barley rise, and a buyer enters into a contract to sell the same quantity at the then market price,

136 CASAC report para 3.44.

> the "value of the arrangement" from the buyer's point of view will increase by the increase in market price.[137]

However, the Court expressed reservations about this view:

> the words the value of the arrangement are very broad, and, if the plaintiffs' submissions are correct, many transactions would be derivatives, even though they would not be considered to be derivatives as a matter of ordinary language. Almost all forward contracts for goods which are readily obtainable in the market would be caught. ... I acknowledge the fact that there are the exceptions in s 761D(3) but even so, one is cautious of an interpretation of subs (1) which would catch an ordinary transaction like the sale and purchase of a motor vehicle with payment of the purchase price today and delivery in one week's time.[138]

On appeal, the Full Federal Court expressed reservations about the view expressed at first instance. The Full Federal Court was 'inclined to the view that if the value of an arrangement (whatever that term means) may vary with fluctuations in the price of the grain in question or some other grain, then the [derived value element] may be satisfied'.[139] However, the Court expressed reservations about how to value non-contractual arrangements and what meaning might be given to the term 'consideration' in relation to those arrangements.[140] The Full Federal Court in this case upheld the

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137 *Keynes v Rural Directions Pty Ltd (No 2)* [2009] FCA 567 at [84].

138 *Keynes v Rural Directions Pty Ltd (No 2)* [2009] FCA 567 at [87]. These views were obiter dicta, as the Court had ruled that the forward contracts under consideration were not derivatives as they fell within the exception for arrangements for physical delivery of tangible property that are not capable of close-out (s 761D(3)(a); see also Corp Reg 7.1.04(4)).

139 *Keynes v Rural Directions Pty Ltd* [2010] FCAFC 100 at [62].

140 The Court said (at [26]):

decision of the Federal Court at first instance that the forward contracts for the supply of wheat and barley were not derivatives on the grounds that they fell within the exception in s 761D(3)(a) to the definition of derivative: see further Section 4.3 of this report.

On one view, the argument put to the Court at first instance and the comment of the Full Federal Court concerning the application of the derived value element were correct. The value of an arrangement can vary over time, even if the consideration under that arrangement stays the same. This was recognised on appeal in another case.[141]

> One may doubt whether such contracts satisfy the requirements of s 761D(1) so as to be derivatives, quite apart from the operation of s 761D(3). Clearly, the amount of the consideration will not vary. The applicants rely on the words “the value of the arrangement”. The meaning of that expression is obscure. One immediately asks: “The value to whom?” It may be arguable that if prices rise, the value of the contract to the buyer will rise. It may similarly be arguable that if prices fall, the value to the seller will rise. In each case, the value depends upon the enforceability of the contract. If the arrangement in question is not a contract, then how is it to be valued? Yet the definition of the term “arrangement” clearly contemplates non-contractual arrangements. This line of reasoning might provoke questions concerning the meaning of the term “consideration” in a non-contractual arrangement, leading in turn to an inquiry as to how a party might be required to provide consideration for the purposes of s 761D(1)(a) in a non-contractual context. It may be that it is impossible to work out the actual operation of s 761D(1) other than for a specific “arrangement”.

Also, Giles JA in *International Litigation Partners Pte Ltd v Chameleon Mining NL* [2011] NSWCA 50 observed (at [48]) that:

> The value of an arrangement to a party to it is not necessarily the same as the consideration it will receive; for example, the costs of performance by that party must be taken into account.

141 In *International Litigation Partners Pte Ltd v Chameleon Mining NL* [2011] NSWCA 50, Giles JA said at [53], [62]:

> A particular difficulty is that para (a) of s 761D(1) refers to provision of consideration, but when one comes to para (c) it refers also to the value of the arrangement as a factor additional to the amount of the consideration, the affectation of which by itself can satisfy the paragraph. Value to whom, and how is it ascertained? One way this can operate is if the value of the arrangement is seen as an extended correlative of the amount of the consideration, although it is not the same as the amount of the consideration; from the point of view of its recipient under the arrangement, the consideration is one of all the elements in the arrangement from which the value of the arrangement to that party is ascertained. Adopting the trial judge’s use of “affected by” as shorthand for the determination, derivation or variation to which para (c) refers, in such a case it is not easy to see that the additional factor adds anything to the working of the definition, since if the amount of the consideration is relevantly affected, so is the value of the arrangement likely to be affected.
>
> … Correctly, in my view, it submitted that the trial judge conflated the two statutory criteria of the amount of the consideration and the value of the arrangement, and did not allow for the different operation of the latter concept.

The concerns expressed about how forward contracts over tangible property would be treated in the absence of an exception indicate the potential for the definition of derivative to apply to forward contracts over intangible property that might not normally be considered to be derivatives (for instance, the transfer of intellectual property rights by an artist).

Even if a forward contract were to fall outside the definition of derivative, it may still be a financial product if it is a facility for the management of financial risk.[142]

Concept of 'ultimately determined' by 'something else'

In *Chameleon Mining NL v International Litigation Partners Pte Ltd* [2010] NSWSC 972, and on appeal in *International Litigation Partners Pte Ltd v Chameleon Mining NL* [2011] NSWCA 50, various views were expressed on the possible meaning of these phrases in s 761D(1)(c). The issue was whether a litigation funding deed was a derivative. One argument put forward was that the deed was a derivative because the return to the litigation funder pursuant to the deed was ultimately determined by reference to, and varied according to, something else, being the outcome of the litigation.

The Court at first instance rejected that contention on the ground that the 'ultimately determined' element of s 761D(1)(c) was not satisfied.[143]

On appeal, various approaches were taken by the members of the Court of Appeal in determining, by majority, that the litigation funding deed was not a derivative. One majority judge ruled that the 'something else' element s 761D(1)(c) was not satisfied.[144] The other majority judge considered that the elements of s 761D(1) had been satisfied, but that the deed was a contract for the future provision of services, and therefore came within the exclusion from the definition of derivative under s 761D(3)(b). The dissenting judge considered that the elements of s 761D(1) had been satisfied and that

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Young JA in that case, in taking the view that the litigation funding agreement was not a derivative, discussed the derived value element at [225]-[238]. His comments included some observations on wording difficulties in the section.

142 ss 763A(1)(b), 763C.

143 [2010] NSWSC 972 at [78]-[79].

144 [2011] NSWCA 50 at [236]-[238] per Young JA.

the exception for the future provision of services did not apply because the deed was a contract for the provision of money.

Time value of money

A concern that has been expressed is that almost every executory contract of more than trivial duration may be a derivative under the current definition of derivative because of the derived value element, given that the value of such contracts must be derived from or vary by reference to the time value of money.

4.3 Arrangements for mandatory physical delivery of tangible property

4.3.1 Elements of this exception

A forward agreement is not a derivative to the extent that it deals with a transaction involving a purchase and sale that:

- *relates to tangible property (the tangible property requirement).* A party must have an actual or potential obligation to buy, and another party must have an actual or potential obligation to sell, tangible property (other than Australian or foreign currency) at a price and on a date in the future (paragraph (i) of the exception)
- *can only be settled by physical delivery (the mandatory physical delivery requirement).* There must be no means other than physical delivery to settle the seller's obligations under either:
  - the arrangement itself (the arrangement must not permit the seller's obligations to be wholly settled by cash, or by set-off between the parties) (paragraph (ii) of the exception)
  - usual market[145] practice or the rules of a licensed market or of a licensed clearing and settlement facility (these should

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[145] The Court in *Keynes v Rural Directions Pty Ltd* [2010] FCAFC 100 at [58] said:

> No consideration has been given to the meaning of the term "market" in s 761D(3)(a)(iii). The term may be used to denote an identifiable market in which traders participate. It is unlikely that the term is used in the sense in which it is used in the economic context as a construct for economic analysis. It is possible that any relevant market (not being licensed or having rules) may only be identifiable by reference to its usual practices.

not permit the seller's obligations to be closed out[146] by the matching up of the arrangement with another arrangement of the same kind under which the seller has offsetting obligations to buy) (paragraph (iii) of the exception).[147]

At least one purpose of this exception is 'to distinguish between transactions on futures markets and transactions which are, in fact, merely contracts for the sale and purchase of grain'.[148]

The legislative intention is that a forward agreement that comes within this statutory exception to a derivative is also not a financial product.[149]

4.3.2 Judicial observations on this exception

The possibility that damages may be payable does not exclude the mandatory physical delivery requirement. The Federal Court at first instance in one case said:

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146 The Court in *Keynes v Rural Directions Pty Ltd* [2010] FCAFC 100 at [49]-[50] considered it likely that 'close out' had the meaning used in the Macquarie Dictionary (4th ed, 2005): 'to nullify one's position in the futures market either by selling (from a bought position) or buying (from a sold position)'.

147 s 761D(3)(a). As indicated in the Revised Explanatory Memorandum to the Financial Services Reform Bill 2001 paras 6.80-6.81, the mandatory physical delivery requirement was based on the CASAC report, which said (at para 3.46):

> Only those contracts under which physical delivery of a commodity, other than a currency, is mandatory should be excluded from the derivatives definition. Physical delivery would not be mandatory if the possibility of close-out existed. The Committee recognises that a vendor who does not own the property the subject of a mandatory physical delivery forward transaction has the same exposure and therefore creates the same counterparty credit risk as if the arrangement were to be cash-settled. However, without this physical delivery exclusion, the derivatives definition would unnecessarily regulate ordinary commercial forward agreements.

In relation to the market practice component of the physical delivery requirement, the Court in *Keynes v Rural Directions Pty Ltd (No 2)* [2009] FCA 567 at [80] said:

> the market practice ... is one whereby the seller's obligations are for all practical purposes brought to an end upon the entering into of the offsetting arrangement.

148 *Keynes v Rural Directions Pty Ltd* [2010] FCAFC 100 at [53].

149 s 765A(1)(n). This contrasts with an arrangement that comes within any other exception to the definition of derivative, which may still be a financial product under another test of financial product (ss 763A, 764A).

Paragraph 765A(1)(n) only refers to an agreement that comes within s 761D(3)(a). However, a forward agreement for mandatory physical delivery of tangible property also comes within the exception to a derivative in Corp Reg 7.1.04(4)(a) (the equivalent of s 761D(3)(a)), which is not covered by s 765A(1)(n).

> the option wholly to settle an obligation by cash must be in the arrangement, it must be vested in the seller and the alternatives of paying cash or delivering the property must be of a similar nature or standing. The "option" of paying damages is not an option provided by the arrangement, nor is it of a similar nature or standing as the obligation to deliver the property.[150]
>
> The obligation to pay damages arises when the seller breaches his obligations, not when he settles them ... There is also force in the submission of counsel for ABB Grain that it is inherently unlikely that Parliament would have intended that the application of a provision such as [the physical delivery requirement under the arrangement itself], with all the consequences that flow therefrom, would turn on whether the discretionary remedy of specific performance was likely to be awarded.[151]

Also, arrangements entered into to offset adverse market movement do not constitute 'close-out' within the meaning of paragraph (iii).[152]

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150 *Keynes v Rural Directions Pty Ltd (No 2)* [2009] FCA 567 at [71]. The Court cited the following passage from *Coulls v Bagot's Executor and Trustee Co Ltd* [1967] HCA 3; (1967) 119 CLR 460 (at 504):

> The primary obligation of a party to a contract is to perform it, to keep his promise. That is what the law requires of him. If he fails to do so, he incurs a liability to pay damages. That however is the ancillary remedy for his violation of the other party's primary right to have him carry out his promise. It is, I think, a faulty analysis of legal obligations to say that the law treats a promisor as having a right to elect either to perform his promise or to pay damages.

The Full Federal Court in *Keynes v Rural Directions Pty Ltd* [2010] FCAFC 100 at [41] adopted the observations in *Coulls* and those of the primary judge. In that judgment, the Full Federal Court observed (at [31]):

> In other words, an award of damages for breach of contract is compensation for failing to meet one's obligations. It does not reflect an implied contractual arrangement which permits an obligation under the contract to be wholly settled in cash. It may be rare for a court to order specific performance of a contract for the sale of goods, but the theoretical availability of that remedy also says much, in principle, against the applicants' argument.

The Full Federal Court also said (at [41]):

> The statutory provision contemplates an "arrangement" which permits, in the sense of authorizing, … settlement [wholly in cash or by way of set-off]. That permission must be, in effect, an alternative form of performance contemplated by the contract and at the seller's election. In our view, it cannot be merely a possible alternative means of performance after cancellation of the obligation to deliver under the contract, dependent upon the buyer's concurrence.

151 *Keynes v Rural Directions Pty Ltd (No 2)* [2009] FCA 567 at [72].

152 In *Keynes v Rural Directions Pty Ltd (No 2)* [2009] FCA 567 at [79-80], the Court said:

4.4 Other exceptions

4.4.1 Contract for the future provision of services

There are no relevant definitions to assist in interpreting this exception, which was not included in the CASAC report.[153]

The view was taken in one case that this exception covers providing payment for the provision of services, as well as the provision of services itself.[154]

> … it is possible, or known, or not uncommon, for a seller who is facing a production failure to agree to buy an amount equivalent to what he has agreed to sell, thereby capping a loss in a rising market or making a profit in a falling market. I do not think that is what paragraph (iii) means and it follows that, even if the plaintiffs established at trial the market practice they identified, it would not assist them. Therefore, the question of market practice is not a triable issue upon which the plaintiffs' case depends.
>
> It seems to me that what the plaintiffs identified is not a usual market practice permitting the closing out of the seller's obligations by the means specified. What the plaintiffs identified was a means of making a profit or capping a liability in a market where goods are readily obtainable. It is the nature of the goods, not usual market practice, which permits the seller to act in the way specified. It is also important to note that what must be closed out are the seller's obligations.

Similarly, in *Keynes v Rural Directions Pty Ltd* [2010] FCAFC 100, the Full Federal Court (at [58]) said:

> a practice must be more than a way in which a seller seeks to minimize loss or potential loss under a contract into which he or she has entered.

153 s 761D(3)(b), Corp Reg 7.1.04(6). See the comments of Giles JA (at [82]) and Hodgson JA (at [133]) in *International Litigation Partners Pte Ltd v Chameleon Mining NL* [2011] NSWCA 50. See also the comments of Young JA at [241].

154 In *International Litigation Partners Pte Ltd v Chameleon Mining NL* [2011] NSWCA 50 at [132]-[133], Hodgson JA said:

> The intention disclosed, in my opinion, is that where what determines the amount to be paid at some future time is the future provision of services, the extent or value of which is presently uncertain, or the outcome of which provision is presently uncertain, the arrangement should not be caught by the definition. That consideration applies equally where what is provided in the future is not of the nature of tasks undertaken, but rather of the nature of the procuring by payment for the undertaking of such tasks; and also in my opinion where what is provided is finance for the party which has the obligation to make the later payment to undertake a venture which may produce a benefit for both parties.
>
> There is no definition of "provision of services" or of "services". In my opinion, it extends to a case where the arrangement requires the party which is to receive the later payment, to make payments which procure services from third parties, and also to cases where the services to be provided are services by way of providing finance for an undertaking by the party which is to make the later payment.

4.4.2 Other types of financial product

An arrangement will not be a derivative if it is covered by one of the other categories of financial product.[155] This 'trumping' arrangement was discussed in chapter 3.

4.4.3 Arrangements providing for inflation-adjusted consideration

Under this exception, an arrangement is not a derivative merely because it provides for the consideration to be varied by reference to a general inflation index such as the Consumer Price Index.[156]

4.4.4 Anything declared by the regulations not to be a derivative

The CASAC report concluded that:

> the only feasible method of excluding inappropriately regulated products from the derivatives definition is by regulation or by specific exemption of classes of agreements.[157]

The Corporations Regulations definition of derivative contains the same exceptions as the Corporations Act definition. Currently, the regulations do not declare anything else not to be a derivative.

ASIC does not have a power to declare something not to be a derivative. By contrast, it has a power to declare something not to be a financial product.[158]

4.4.5 Exceptions from the financial product definition

In addition to the exceptions from the definition of derivative, there are various exceptions from the definition of financial product (for instance, for something that is a credit facility[159] or that is only incidental to a larger whole that does not have a financial product

155 s 761D(3)(c), Corp Reg 7.1.04(7).
156 s 761D(4), Corp Reg 7.1.04(5).
157 para 3.60.
158 s 765A(2).
159 s 765A(1)(h). The credit facility exception is discussed in *International Litigation Partners Pte Ltd v Chameleon Mining NL* [2011] NSWCA 50 per Giles JA at [76]-[80], Hodgson JA at [134]-[137], Young JA at [211]-[220].

purpose[160]). Something that falls within one of the latter set of exceptions will not be a financial product, and hence will avoid the regulatory consequences of being a financial product, even if it satisfies the tests for being a derivative.

4.5 Power to designate products as derivatives

4.5.1 Australian approach

The general approach in the Corporations Act has been to emphasise the regulation-making powers as the appropriate way to adjust the definition of derivative or financial product, if necessary. The regulations may declare something to be, or not to be, a financial product,[161] or to be, or not to be, a derivative.[162] ASIC can declare something not to be a financial product.[163]

4.5.2 New Zealand

The New Zealand *Financial Markets Conduct Bill* (2011), in addition to including a list of derivatives in the generic definition (see Section 4.1.3 of this report), would give the New Zealand regulator, the Financial Markets Authority (FMA), broad-ranging declaration powers concerning the classification of financial products.

The draft Bill regulates four defined categories of financial products:

- equity securities
- debt securities
- managed investment products
- derivatives.

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160 s 763E. This exception is discussed in *International Litigation Partners Pte Ltd v Chameleon Mining NL* [2011] NSWCA 50 per Giles JA at [89]-[92], Hodgson JA at [122]-[128] and Young JA at [164]-[182].

161 ss 764A(1)(m), 765A(1)(y).

162 s 761D(2), (3)(d).

163 s 765A(1)(z), (2).

The FMA is to be given a ‘declaration’ power that will allow it to move products between categories, to clarify that a given product is in a particular category, and also to ‘call in’ products that appear to fall outside any of the categories (and which therefore fall outside the definition of ‘financial product’ and would otherwise be unregulated).

To do this, clause 512 of the draft Bill provides:

> (1) The FMA may—
>
> (a) declare that a security [see definition, below] that would not otherwise be a financial product is a financial product of a particular kind [the ‘call in’ power]
>
> (b) declare that a financial product is, or is to become, a financial product of a particular kind (whether or not it was previously a financial product of a different kind)
>
> (c) declare that a security that would otherwise be a financial product of a particular kind is not a financial product.

The definition of ‘security’ in the draft Bill is very broad, and includes any ‘arrangement or… facility that has, or is intended to have, the effect of a person making an investment or managing a financial risk’.

For example, if there is uncertainty about whether a new product should be treated as a derivative, the FMA can declare that it is, or is not, a derivative. The product will then be treated/not treated as a derivative in any subsequent offers. (The declarations do not have retrospective effect.)

Before making a declaration, the FMA is required to be satisfied that the declaration is necessary or desirable in order to promote the purposes of the Bill, to have regard to the economic substance of the product, and to consult the persons that the FMA considers will be substantially affected by the declaration.

The reasons put forward for this foreshadowed designation power are that:

- there can be uncertainty about where some products (especially novel products) sit in the product classification scheme. The designation process creates a low-cost mechanism for resolving these issues that (unlike guidance) is legally binding

- products may be created that sit, for technical legal reasons, within the definition of one type of financial product, but that are, in economic substance, another type of product, and ought to be regulated as such. The designation power helps to ensure that products are regulated according to their economic substance and not their legal form

- one of the major problems with any set of definitions of what is to be regulated is the incentive that it may create for issuers to structure their products to avoid falling within the definitions. A typical legislative response to this is to use very wide definitions – for example, a very wide definition of 'financial product'. However, this may result in products and contracts that, in economic terms, are not financial products falling within the definition, resulting in unwarranted regulation and the need for extensive exemptions. The designation power allows the draft Bill to adopt a less all-embracing definition of 'financial product', as issuers who try to avoid the definition can always be 'called in'.

The New Zealand proposals would give the FMA greater declaratory powers in this respect than are available to ASIC, which, as previously indicated, only has power to declare something not to be a financial product.

4.6 CAMAC position

4.6.1 General approach in s 761D

CAMAC considers that the current definition of derivative in s 761D is suitable and adequate, with the intended breadth of the definition allowing for its application to innovative derivative products without disruption to the regulatory structure of derivatives markets. In this way, the existing definition is consistent with the regulatory objectives underpinning Chapter 7 of the Corporations Act.

CAMAC does not believe that it is necessary to adjust or supplement the definition with a list of particular financial products. Product descriptions in the market may change over time, so that current legislative descriptions of particular products may not be appropriate in the future. Also, the terms used in any core list of products that are derivatives may themselves require definition, which further complicates the process of defining 'derivative'. By contrast, the principles-based approach in s 761D is flexible enough to include new products as well as allow for new terminology for existing products, as it deals with the substance of a product rather than its form or market description.

While the definition of derivative in s 761D differs from the definition in the accounting standards, CAMAC notes that the definitions are used for different purposes and is not aware that this has caused any confusion or difficulties in practice.

4.6.2 Future liability and derived value elements

Future liability

As previously noted, in regard to the future time requirement, certain intra-day transactions are included by virtue of s 761D(2) and Corp Reg 7.1.04(2), while s 761D(1)(b) only covers longer-term transactions.

CAMAC considers that this drafting approach, while possibly inelegant, does not point to the need for an amendment to s 761D(1). There is no evidence of wide-scale industry confusion or uncertainty on this matter.

Derived value: 'something else'

Paragraph 761D(1)(c) includes the notion of the amount of the consideration or the value of the arrangement being ultimately determined by, derived from or varied (in whole or part) by the value or amount of 'something else'. There is a debate about the width of this expression, in particular, whether 'something else' includes 'events' and, if so, whether certain events, such as sporting or election outcomes, should be excluded from the definition.

CAMAC considers that, consistently with the original intention that the definition of derivative be broad-ranging, the phrase 'something else' should, in principle, be sufficiently general to include anything that could be described as an 'event'. However, to avoid the definition having too broad an application, certain types of sporting or other events could be carved out from the definition of derivative by exercise of the regulation-making power under s 761D(3)(d).

Exercise of this exemption mechanism could ensure that activities unrelated to financial services and markets are not inappropriately caught within the definition of derivative, while also reinforcing the legislative intention that 'events' otherwise come within the concept of 'something else'.

Derived value: time value of money

CAMAC does not consider that a statutory amendment is necessary to take into account that the value of an arrangement may ultimately be determined by reference to the time value of money. CAMAC's consultations have not revealed any market concern that the definition of derivative in s 761D could unintentionally apply to transactions that have no elements that would come within s 761D(1) other than a possible link to the 'time value of money'.

4.6.3 Arrangements for mandatory physical delivery of tangible property

CAMAC considers that the current statutory definition suitably regulates forward contracts over tangible property. The effect of s 761D(3)(a)(ii) and (iii) is that these contracts are exempt from the definition of derivative only if physical delivery of the tangible property by the seller is mandatory. CAMAC considers that contracts over tangible property which have no off-settable or tradeable characteristic are not derivatives on any proper economic or market analysis.

CAMAC therefore considers that no amendment to s 761D is necessary to deal with the different types of physically settled forward contracts.

4.6.4 Regulation-making powers

There are regulation-making powers in s 761D(2) and s 761D(3)(d) to declare something to be/not to be a derivative.

CAMAC has already referred to the possibility of using these powers to declare transactions related to certain future 'events' not to be derivatives.

CAMAC also notes that some of the recent case law on s 761D set out in this report deals with arrangements at the margin, such as litigation funding contracts. Partly for this reason, courts have had some difficulty applying some of the concepts in s 761D. This may give a false impression that the legislative concepts are more problematic for mainstream derivative products than is in fact the case.

One way to deal with any future problematic judicial decisions in peripheral areas is through the powers to enact regulations declaring something to be/not to be a derivative, rather than through attempts to redesign the legislation to cater for these outcomes. Equally, the regulation-making power could be used, where appropriate, to deal with the emergence of new financial instruments.

4.6.5 Power to designate products as derivatives

CAMAC considers that, taking into account the regulation-making powers, there is no clear and compelling need to introduce a mechanism empowering ASIC to declare an arrangement to be a derivative.

4.6.6 Other matters

The reference from the PST asked CAMAC to consider whether there are any other ‘options to decrease complexity in this area of the law’.

CAMAC considers that the s 761D definition of derivative is not unduly complex. It is a broad principles-based definition, tempered by specific exclusions and the ability, if necessary, to enact regulations that make further adjustments in response to developments in the market. CAMAC is comforted in coming to this view by the fact that none of the participants at the Roundtable considered that the definition was unduly complex.

Appendix Concept of a financial product

The concept of a 'financial product' for the purposes of Chapter 7 of the Corporations Act was introduced in 2002, as part of a move to a more competitively neutral financial system, following the 1997 report of the Financial System Inquiry (the Wallis report).

Part 7.1 Division 3 of the Corporations Act contains:

- a general definition of financial product[164]
- a legislative list of specific things that are financial products[165]
- a legislative list of specific things that are not financial products.[166]

The regulations may declare something to be, or not to be, a financial product.[167] ASIC can also declare something not to be a financial product.[168]

There is also a definition of 'financial product' in the ASIC Act,[169] for the purposes of applying the consumer protection provisions in that Act.

The general definition of a financial product

Under the general definition of financial product,[170] a financial product is a facility[171] through which, or through the acquisition of which,[172] a person:

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164 ss 762A(1), 763A-763E.
165 ss 762A(2), 764A.
166 ss 762A(3), 765A.
167 ss 764A(1)(m), 765A(1)(y).
168 s 765A(1)(z), (2).
169 ASIC Act s 12BAA.
170 s 763A. This has effect subject to s 763E, which exempts something from being a financial product if it is only an incidental part of a larger whole that is not a financial product.
171 There is a wide definition of 'facility' in s 762C, which includes an arrangement.

- makes a financial investment,[173] and/or
- manages financial risk,[174] and/or
- makes non-cash payments.[175]

Making a financial investment

The concept of a financial investment has been broadly interpreted. In *ASIC v Money for Living (Aust) Pty Ltd (Administrators Appointed) (No 2)* [2006] FCA 1285, the Federal Court held that a marketing arrangement whereby persons sold their homes and then leased them back for the remainder of their lives constituted a financial investment. The arrangement thereby involved the marketing of a financial product.

Managing financial risk

The concept of managing financial risk is particularly relevant to arrangements that might be considered to be derivatives, as financial risk management is one of the major purposes for which derivatives are used. Even if an arrangement falls outside the definition of derivative or falls within one of the exceptions to that definition, it may nevertheless be a financial product on this ground.

Persons manage financial risk if they:

- manage the financial consequences to them of particular circumstances happening; or
- avoid or limit the financial consequences of fluctuations in, or in the value of, receipts or costs (including prices and interest rates).[176]

The concept has been broadly interpreted. In *International Litigation Partners Pte Ltd v Chameleon Mining NL* [2011] NSWCA 50, the Court held that a litigation funding deed was a financial product, as

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172 In *International Litigation Partners Pte Ltd v Chameleon Mining NL* [2011] NSWCA 50, Giles JA said (at [44]) that 'the word "through" calls attention to the operation or effect of the facility and not to the purpose of the person'.

173 s 763B.

174 s 763C.

175 s 763D.

176 s 763C.

it was a facility for the plaintiff to manage its financial risk of adverse cost orders and losses in litigation. The majority also held that the 'incidental product' exception[177] did not apply.[178]

Specific things that are financial products

The things that fall into this category are financial products, whether or not they are within the general definition,[179] unless they also happen to fall into the category of things specifically excluded (see below).

Derivatives are specified as being financial products.[180] Other things that are specified as being financial products are:

- securities[181] and
- interests in registered and unregistered managed investment schemes[182]

as well as various other things.[183]

If a financial product that is covered by the definition of derivative is also within one of the other categories of financial product, it is treated as the other type of financial product, not a derivative.[184]

Specific things that are not financial products

Section 765A sets out specific things that are not financial products.

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177 s 763E.

178 In October 2011, the High Court granted leave to appeal.

179 ss 762A(2), 764A.

180 s 764A(1)(c). The Court in *International Litigation Partners Pte Ltd v Chameleon Mining NL* [2011] NSWCA 50 said (at [51]) that:

> A derivative is a financial product in its own right, whether or not it is within the general definition (s 762A(2)) and so whether or not anyone makes a financial investment under s 763B.

181 s 764A(1)(a).

182 s 764A(1)(b), (ba).

183 Contracts of insurance, life policies, superannuation interests, retirement savings accounts, first home saver accounts, deposit-taking facilities, government debentures, stocks or bonds, foreign exchange contracts that are not derivatives or are not to be settled immediately, and margin lending facilities (s 764A(1)(d)-(l)), as well as anything declared by the regulations to be a financial product (s 764A(1)(m)).

184 s 761D(3)(c), Corp Reg 7.1.04(7).