COMMONWEALTH OF AUSTRALIA

JOINT COMMITTEE

on

CORPORATIONS AND SECURITIES

(Reference: Statutory monitoring role: role of the Companies and Securities Advisory Committee

CANBERRA

Wednesday, 29 March 1995

OFFICIAL HANSARD REPORT

CANBERRA

JOINT STATUTORY COMMITTEE ON CORPORATIONS AND SECURITIES

Members:

Mr Stephen Smith (Chair)
Senator Gibson (Deputy Chair)

Senator Cooney	Mrs Bishop
Senator McGauran	Mr Humphreys
Senator Neal	Mr Sinclair
Senator Spindler	Mr Tanner

Matter referred:

Statutory monitoring role: role of the Companies and Securities Advisory Committee.

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WITNESSES

JOINT STATUTORY COMMITTEE ON CORPORATIONS AND SECURITIES

Statutory monitoring role: role of the Australian Securities Commission

CANBERRA

Wednesday, 29 March 1995

Present

Mr Stephen Smith (Chairman)

Senator Gibson	Mr Humphreys
Senator Spindler	Mr Sinclair
	Mr Tanner

The committee met at 12.43 p.m.

Mr Stephen Smith took the chair.

CAMERON, Mr Alan John, Chairman, Australian Securities Commission, Level 16, Chifley Tower, 2 Chifley Square, Sydney, New South Wales 2000,

PALMER, Ms Kerrie Elizabeth, Manager, Policy, Australian Securities Commission, Level 16, Chifley Tower, 2 Chifley Square, Sydney, New South Wales 2000, and

RODGERS, Mr Malcolm James, Special Policy Adviser, Australian Securities Commission, Level 16, Chifley Tower, 2 Chifley Square, Sydney, New South Wales 2000

were called to appear before the committee.

CHAIR—I welcome Mr Alan Cameron, Chairman of the Australian Securities Commission, and other officers of the commission to this public hearing of the Joint Committee on Corporations and Securities. The purpose of the hearing is to ensure that the committee and the parliament are informed about the administration of the national scheme of corporate law which the ASC is charged with administering, and in particular, the context of the regulation of derivatives in light of the collapse of the Barings Bank.

The question of derivatives will be of keen interest to the committee this afternoon but in addition to that there will be a number of other matters which I am sure members of the committee will raise with you, none of which I am sure will surprise.

In accordance with our usual practice, Mr Cameron, you are quite welcome to make an opening statement if you so choose.

Mr Cameron—Thank you, Mr Chairman. I will make a short opening statement to try to set some of these matters in context as far as the ASC is concerned. Perhaps I should say firstly that over the last year the ASC has been reviewing in detail its arrangements for the supervision of exchange based futures markets and that that has led, among other things, to the signing of a memorandum of understanding with the Sydney Futures Exchange in June last year.

That memorandum provides for immediate referral to the ASC of matters which come to the attention of the futures exchange that may constitute serious breaches of its business rules or of the Corporations Law, and such matters, as well as being serious breaches of market or member client obligations, include any matter which may result in the failure of a broker member of the exchange. Fourteen such referrals have been made since June 1994 but clearly none of them have had the same sort of consequence as the Barings matter.

We have also established and resourced a specialist futures industry team in the New South Wales regional office. The futures industry in Australia is largely centred in Sydney and that is the reason why the team is there. During 1994 we arranged for the United States Commodity Futures Trading Commission, which regulates the futures industry in the United States, to second to us a senior officer to act as a consultant to review the effectiveness of the Sydney Futures Exchange's supervision of its trading and to advise us on the carrying out of such reviews on a regular basis. That officer gave the exchange and the commission a very favourable rating on the exchange's regulatory performance.

The ASC is currently building on these arrangements to ensure that the future supervision of the SFE markets is based on a sensible use of resources and on clearly delineated roles for the exchange and the commission. For example, it is our view that we will contribute most effectively not by having a system of parallel supervision of the market and the members but by conducting periodic intensive audits of the effectiveness of the Futures Exchange's supervision in these areas.

We have also entered into memoranda of understanding with the Stock Exchange that are similar in effect to the memorandum of understanding with the Futures Exchange and the result of those is that the arrangements apply to its derivatives market as well as to its securities market.

I suppose the other major thing that has been attracting attention is the over-the-counter derivatives markets and we have since late 1992 undertaken a series of projects about those markets as well. I think that has happened because as those markets have been

maturing there has been a trend towards them heading towards the retailer end of the market and not staying entirely professional. That certainly required some attention as did the extremely rapid growth and shear size of these derivatives markets which internationally have raised questions about the adequacy of the regulatory regime. In Australia our regime has remained basically unaltered for about 10 years so it clearly has required some attention.

In a paper that is almost ready to be handed to you I have listed all of the activities that we have undertaken in the course of that time including reviewing the question of exempt futures market status for various applicants. That has now led to the Attorney-General granting that status to 35 major merchant banks and investment banks and there are various draft policy statements and draft reports floating around about which I think you are probably already informed.

The major outcome though is a law reform review which is being undertaken by the Companies and Securities Advisory Committee of which I am also a member, and we have been actively involved in that. The commission is also an active member of the various international organisation of securities commissions forums at which the regulation of these markets is regularly discussed.

One aspect of the markets which has been highlighted by us is the current lack of accounting and disclosure standards applying to the derivatives activities of both market providers and market users. We have been calling for the development of appropriate standards, although we are well aware that that is not a straightforward thing to do and that it will take some time. So, as an interim step, the commission has been working in conjunction with the Australian Society of Corporate Treasurers to publicise and encourage the adoption of best practice disclosure guidelines for corporate users of derivatives. These guidelines are expected to be available in time for accounts prepared as at 30 June this year.

The paper I have in front of me is far too long even to summarise, so I am going to jump straight away to a couple of the more particular issues. In relation to the share ratios bill and the question of Stock Exchange-Futures Exchange relationships, as part of

this exercise that I have just referred to, we called for a fundamental review of the law dealing with derivatives. But, as an interim measure, we have supported the introduction of more flexibility in the law to deal with emerging issues in these rapidly changing market circumstances, especially with those products that have characteristics of both securities and derivatives. We have noted the emergence over the last 12 months of some intense competition between the Futures Exchange and the Stock Exchange.

The ASC has suggested that while adjustment of the scope of the share ratios bill, and so on, could be a matter of regulation, it may be more appropriate for the ASC to be empowered to determine the content of the regulation that should apply to instruments that are declared under the proposed amendments. I understand the amendments have been passed and this is probably now gratuitous in that sense, but we were merely going to make the point that if the commission were given the power of declaring the content of the hybrid instruments, it would have enabled them to be altered more readily and also for our decisions to be subject to administrative review, which would have enabled any concerns raised by either of the competitors to be dealt with in the Administrative Appeals Tribunal. But, in any event, we are basically quite happy with the structure of the share ratios bill.

I would now like to say a few words about Barings. The first thing I would say is that the facts about the Barings collapse may still not be known for some time. Investigations in various countries and at various levels are under way, but the ASC is confident that we will get full details of what is discovered as they emerge. We expect to receive information from the Monetary Authority of Singapore, the Securities and Investment Board in the United Kingdom, the Securities Bureau of the Japanese Ministry of Finance, and both the Commodity Futures Trading Commission and the Securities and Exchange Commission of the United States. So these comments that I am about to make are preliminary and are based on the ASC's analysis of publicly available information, and they may require some modification as the facts become clearer.

The collapse of Barings is, of course, the latest in a line of large disasters reported by derivatives market participants. Among them are the German industrial conglomerate,

Metallgesellschaft; US corporates such as Procter and Gamble, and Gibson Greeting; and, to the extent that it involved derivatives, Orange County, in California. I might say that the current edition of *Fortune* magazine from the United States has a very interesting article on all of the others, and not Barings. It was clearly written prior to Barings, but for a very useful and readable description of what happened in all of the ones I have just referred to, you cannot go past that *Fortune* magazine article. I unfortunately only have a photocopy of a fax of it, and I am sure your parliamentary library will do better than that.

Mr SINCLAIR—I did not think the ASC budget was that strained!

Mr Cameron—Until Barings, recent regulatory and media attention has focused mostly on the potential risk of over-the-counter derivatives. Two issues have been at the centre of much discussion. Firstly, the risks that are involved in OTC derivatives trading, the complexity of many of the transactions, and consequent doubts as to whether participants—especially corporate users—fully understand and, therefore, adequately manage the risks that they assume in derivatives markets. Secondly, because a comparatively small number of firms dominate market making in these over-the-counter derivatives, the risk that the failure of a significant intermediary, perhaps caused by the default of a major customer, may lead to severe disruption in derivatives markets, or in financial markets generally. This, of course, is known as systemic or interconnection risk.

Numerous studies have been undertaken by a variety of governmental and private sector bodies, both in Australia and elsewhere. But there is, as yet, no general consensus on whether or what additional regulation is required to deal with these issues. One issue on which consensus has emerged is that there is a need for all involved in the derivatives markets to ensure that they understand the transactions they enter into and that they adopt comprehensive risk management structures and practices.

When we look at what has happened in the Barings collapse, some features of the trading and regulatory environment seem to have performed well. In particular, firstly, the clearing system associated with the Simex exchange in Singapore appears to have functioned well. The clearing house was kept in funds. Barings did not in fact default on its margin obligations until the day it collapsed. The ASC understands that the clearing

house has now returned money to the Barings administrators. It also seems that the clearing house queried Barings, including its London management, on a number of occasions from January on, about the size of its positions and its exposure.

Secondly, no client of Barings lost funds deposited with Barings for futures trading purposes. Thirdly, after the failure, there seems to have been effective cooperation between exchanges and regulators in Singapore, Japan, the United Kingdom and the United States. This cooperation concerned identifying, transferring and winding down the positions held by Barings and its clients. Finally, at this stage, there are few signs of significant flow-on or systemic problems caused by the Barings collapse. The speed with which the sale of Barings to ING was effected is likely to have been an important factor in averting the threat of a more general liquidity crisis.

On the other hand, a number of possible problems in the system may be identified in a preliminary way. Firstly, it seems that UK clients of Barings dealt on Simex through an omnibus client account, and were treated as a single client by Barings Singapore. Ultimate client identities were not easily ascertainable. This probably contributed to delay in the transfer of positions to other Simex clearing members, and potentially left clients exposed to continuing deterioration of their positions.

Secondly, prior to the collapse, there seems to have been a lack of transfer of information between exchanges and regulatory authorities in Singapore and Japan. This is likely to have been exacerbated by the fierce commercial competition between Simex in Singapore—which is, after all, a futures exchange—and the Osaka exchange, which is a stock exchange in Japan, for business on the Nikkei 225 index contract, which is listed on both exchanges.

Thirdly, Japanese exchange rules permit house and customer funds to be lumped together for the purpose of calculating margin obligations. That is, the margins that have to be paid relate only to the overall net position of the broker, without regard to the position of the individual clients or the house. This may have complicated or delayed returns to Barings clients in relation to trading in Japan.

Finally, complications with insolvency law across national boundaries seem to have

caused delays in the orderly winding down of positions, including client positions. While all these problems are a source of some concern, it seems that above all it was internal arrangements at Barings that led to its failure. In particular, the following features of internal controls—or lack of them—appear to have been precipitated the collapse.

Firstly, there was the structure of the Singapore branch office, with—it appears—Singapore management having little direct authority over the trading activities of Mr Leeson. Secondly, there was Barings' apparent lack of an effective risk management system, including limits on trading authority and methods of monitoring group exposures on a real time or daily basis. Thirdly, there was the failure by Barings London to verify the accuracy of information supplied by its Singapore office or by individuals within it. Finally, the front office and back office functions in Singapore were not being effectively segregated, so that the person responsible for trading was also authorising trading related payments.

How do we apply those lessons, at this stage—to the extent that you can apply them at all, in Australia? If Barings is seen as an example of the failure of a derivatives market participant because of wrong trading decisions, it is impossible and undesirable to guarantee that it could not happen in Australia or, indeed, in any other jurisdiction. If you view Barings as an instance of how poor management controls can lead to a fatal level of exposure on the wrong side of the market, it is again hard to say that it could not happen here—especially since it already has, some years ago, in the case of AWA.

Despite that, the ASC is reasonably confident that the chances of trading on Australian markets resulting in something on the same scale as the Barings collapse are remote. The way in which the SFE supervises its markets means that a rapid build-up of positions would be likely to be detected and dealt with at an earlier stage than the Barings positions seem to have been, and that the ASC, as regulator, would be involved at an early stage.

But it is not hard to envisage situations which may make the risks larger and the tasks of identifying problems at an early stage more difficult. For example, positions may be held on a number of exchanges in a number of jurisdictions, as they were in the

Barings case, or derivatives market dealings by a large conglomerate may be undertaken through a number of separately incorporated vehicles. It would, therefore, be a mistake to be entirely sanguine about the possibility of a Barings happening in Australia. Equally, the ASC believes that the regulatory regime should not be seen as a panacea. Barings should not result in a 'there ought to be a law against it' response. As a community, we need to understand clearly what we expect from the regulation of derivatives markets, especially OTC markets. In the ASC's view, what the community looks for primarily ought to be the protection of inexperienced investors, contributions to the stability of markets, and a reasonable assurance that brokers and other market intermediaries have adequate financial resources to honour their obligations to clients and to other market participants. We should not expect regulation to guarantee that no-one fails. Rather, what we should aim for is a system that allows for failure but minimises the damage of fallout in that event.

There have been few instances of the failure of derivatives market intermediaries in Australia since the introduction of the Futures Industry Code in 1986. All date back to the 1980s. Based on experience with these instances, if a failure like Barings did occur in Australia, first, the transfer of client positions to well capitalised members of the SFE would be achieved within 24 hours, and would not stretch out over several weeks, as it appears to have done in Singapore. Second, the segregation of client funds, both at broker and clearing house level, should simplify the identification of all ultimate holders of positions and return of funds to those clients.

As for the segregation of back office and trading functions, that is in fact universal among SFE members, but it is not expressly required by SFE rules or by the Corporations Law. Rather, the futures exchange has a policy of requiring it and would involve general provisions of its rules against a member if non-segregation was detected. Since the Barings collapse, regulators and industry participants alike have focused on the need for derivatives market participants to adopt best practice risk management practices, including structures. The extent to which the regulatory regime should mandate management practices and structures, which of necessity must be appropriate to the circumstances of each firm and capable of rapid change, is questionable. It is doubtful, indeed, whether the

ASC presently has power under the licensing provisions to require the separation of front office and back office functions. Moreover, it is not clear that the regulatory regime should mandate any specific internal management arrangements. To do so may mean that matters which the law currently deals with under the general heading of directors' obligations become the subject of narrow and inflexible rules, and they may provide a false sense of security.

There are only two other brief things I should say. The ASC notes the importance, at times of market emergencies, of the rapid communication of information between regulators and exchanges, both domestically and internationally. The commission advocates amendment to section 127 of the ASC Act to put beyond doubt its ability to release information to foreign exchanges. In view of the need for such transfers of information to happen quickly, the implication of Johns case, which is the case that would require us to consider natural justice implications of such material, may need to be considered in relation to such an amendment.

I do intend to raise with the other members of the Council of Financial Supervisors the possibility of a working group to review methods for the handling of the collapse of a major market participant. That is a suggestion which has been passed on to me from the Stock Exchange. I have already mentioned it to the Governor of the Reserve Bank, and I am sure at our next meeting of the council we will talk about that proposal to see whether it is necessary.

The final thing I would say is this: I am very concerned not to leave the impression that the commission is complacent about Barings or its implications. We certainly did not react complacently. On the day that the announcement was made I spoke to the head of the futures exchange myself on two occasions, and later in the same week. Since 27 February I have discussed the Barings issue at meetings in Kuala Lumpur and Bangkok. At Bangkok there were representatives at the Japanese and Singapore regulators. I spoke in Bangkok also with the Chairman of the UK Securities and Investment Board, and when he came to Sydney the following week, the Council of Financial Supervisors had lunch with him and discussed little else.

There was then a meeting of the international organisation's technical committee in Sydney on 15 March and on that occasion again we had present the Chairman of the Securities and Investment Board, senior members of the Commodity Futures Trading Commission, the Securities and Exchange Commission, the Securities Board from Japan and a representative of the UK treasury. And we have therefore given the matter considerable attention.

A representative for the ASC attended the meeting in Boca Raton, which Mr Hosking spoke to you about when he was giving evidence, and I have therefore a preliminary report from that meeting as well. And it is also true that the Commodity Futures Trading Commissioner and the Securities and Investment Board are proposing a special working group of leading world regulators to review the full implications of the Barings collapse when they emerge. I expect a formal invitation to me to attend that meeting to arrive in the next few days.

So the ASC is not sanguine or complacent about Barings but on the other hand I think we have an equal responsibility to ensure that there is not an overreaction to it or any lack of confidence in what we still believe is one of the better regulated exchanges in the world.

CHAIR—Thank you, Mr Cameron, for that helpful opening statement. There are just a couple of questions I have got before throwing it open to committee members. The first one is that when we heard evidence from Mr Hosking he indicated that the Sydney Futures Exchange was reviewing all of its procedures and arrangements. In your opening statement you referred to a review that you did of the SFE through a United States consultant and you came up effectively ticking the box. Have you been asked to participate in the Sydney Futures Exchange's own review of its own requirements?

Mr Cameron—I do not think we have yet been asked specifically to participate in it. I think on the other hand though that any significant change in their procedures would be discussed with us and may well require amendment to their business rules and so on. I am sure there will be no lack of willingness to talk about these issues and in fact Mr Hosking gave up his Sunday afternoon to address one of our conferences last Sunday on

the subject. There is a great deal of continuing close consideration going on, and I am sure we will be involved in any significant change. The report last year was an overall report and was intended deliberately as a first exercise to ensure that we did have a well regulated exchange by international standards, and the result of the report was clearly to that effect.

CHAIR—The second one is that when we heard evidence from Mr Humphry from the Stock Exchange earlier this week he referred to a proposal the exchange had put to you that a derivatives consulting group be established. Is this the proposal you were referring to earlier?

Mr Cameron—Yes.

CHAIR—All right. I think in your opening statement you covered quite expansively the exchange regulated derivatives trading. With over the counter, what do you see as the vehicle for pursuing the question of lack of regulation or need for more regulation in the over the counter area? Do you see the CASAC review or inquiry as the appropriate vehicle for that? You mentioned you are member of that: what is your direct input?

Mr Cameron—Well, my direct input is a little difficult because I am there as an ex-officio member and the commission might sometimes have a different view from the CASAC view. But on this occasion there is no sign that that is likely to happen. My input is that I attend the meetings and give them the benefit of my views, which of course are educated to some extent by talking to my colleagues at the commission. But I do see the CASAC review as the way and the place for the over the counter issue to be dealt with in this country. We are not alone around the world in having an issue about the extent to which the regulatory system ought to apply to this professional market. One of the difficulties, for example, is that the market is very mobile and if too severe a regulatory regime is imposed in any particular place, it might drive the operation offshore to a less well regulated place. That is not an excuse not to regulate it appropriately. However, there is some real need for Australia to find an appropriate regulatory regime and to ensure that, if it departs in any significant way from what happens elsewhere, there is some real

understanding as to why it should. Certainly, the IOSCO group provides a very good way for Australia to be at the forefront of the leading regulators' approach to these issues and that opportunity is being taken.

Senator GIBSON—My apologies for being late; I got caught in the Senate. It seems to me that what we have in Australia is a pretty good set up really and that, given what you have just outlined for us here this afternoon, we should be reasonably happy with where things are and the way they are being reviewed. I guess my only real concern is in the area of international cooperation and exchange of information, and you have already alluded to it. We all understand that major exposures can be transacted in relatively very short periods. So the matters of what were going to be the triggers and how quickly this exchange of information should take place so that people at the major exchanges do get a feel for major positions being taken by particular players are very difficult problems, are they not?

Mr Cameron—Yes, it is difficult. I mentioned in that opening statement the fact that, if you ask the question of a trader on a particular exchange, you might get an answer that is accurate about that exchange where there is no real ability to conceal it, but you may not get the full picture about associated exposure. For example, the relationship between an exposure on what I will call a physical exchange—on the real exchange as opposed to derivatives exchange—might also be a factor. That is why I think we still need to look at whether the present limitations on the commission's ability to exchange information with other regulators are sufficiently wide. It is a matter that the commission has been talking to the Attorney-General's Department about on and off for some time. It would be better for any doubt to be resolved by making it clear that an overseas regulator is a person with whom we can exchange information. That is not the end of it, because we still need to ensure that the fact that the exchanges are in competition—exactly the situation which occurred in Barings—does not become a reason for regulators and indeed self-regulators, such as the exchanges, to get an incomplete picture about what the real exposures are.

If we were to apply it in Australia, however, the fact that the Futures Exchange—

which I do see as the first line or front-line regulator—goes in, as part of its audit process, and checks the exposures should at least ensure that that corporate entity's exposures worldwide are known about.

Senator GIBSON—I can understand that that is a nice goal to chase. I was just raising the problem of how you actually do this within a short enough time frame when particular traders can trade billions in very short periods. It really is quite difficult to be well informed about when people are, in fact, running past, if you like, exposure limits, which people would like to see as guiding rules.

Mr Cameron—My specialist adviser, Mr Rodgers, might have a particular comment to make.

Mr Rodgers—I think you are right, that is difficult. It is one of the reasons that ASC has been arguing that sensible prudential supervision, particularly of derivatives market intermediaries is necessary—that is establishment of and reporting against some kind of capital standards. One of the effects that we have seen as flowing from that kind of arrangement is that, because there is an obligation to report externally and to consider one's capital in relation to one's exposure, it does encourage the adoption of internal risk management practices which might make everyone feel a little bit more comfortable.

Senator GIBSON—Do you think the major players in the Australian market would welcome your proposal of perhaps having the law changed so that you are more able to exchange information internationally as the ASC?

Mr Cameron—I am not aware that anybody would oppose it as such. It is rather that the language is at the moment, at best, ambiguous. It talks about exchanging information with a foreign government or an agency of a foreign country. I think there is a strong question whether an exchange in a foreign country, an exchange of our own kind, for example, would be regarded as an agency of that country. We would rather not have that doubt because, as you say, this situation might arise as a matter of urgency.

Similarly—Senator Cooney is not here so I can probably get away with this—as to the natural justice implications of the Johns case, we would simply rather not be exposed to them if we were in a market crisis. You can interpret your way around those a bit more

readily than you can around the wording of section 127(4)(c), this issue about the agency, but because the natural justice content in that situation may not involve telling the people anyway. But sometimes these issues have to be confronted. Perhaps the community interest in the security of the market might override, in any event, any individual interest in affording that person who is the subject of the notification full natural justice, before you go talking to other exchanges.

Senator GIBSON—What sort of timing do you see for this review of the law, with respect to the commission which we have just been talking about?

Mr Cameron—On this particular point about exchange of information, it is not on the agenda of anyone in particular. It is not clear what the timing would be. If the committee were interested in it and were to mention it in a report, that would certainly be helpful as far as I am concerned. The overall review of derivatives law has not, at least to date, extended to looking at issues like the exchange of information with regulators. This is more seen as a machinery matter than as part of the substantive review of the law of derivatives.

CHAIR—What do you see as the timetable for the CASAC review?

Mr Cameron—I think you are talking to them tomorrow, so I have to be careful not to anticipate too much. But my understanding is—

CHAIR—This was behind my question!

Mr Cameron—My understanding is that they are hopeful of having their report complete by the middle of the year, meaning June, and the intention would be that—is that still right?

Mr Rodgers—No, my understanding is that a discussion paper completed—

Mr Cameron—I am sorry, I am overstating it. A discussion paper would come out by the middle of the year, that would lead in turn to a draft report later in the year, and a final report perhaps early next year. I had skipped the stage of the discussion paper.

CHAIR—But consistent with your notion of doing it properly and getting it right, rather than doing it quickly in a state of crisis, you would see that as being an appropriate timetable?

Mr Cameron—Yes. I do not think that Barings gives me any reason to think that we are in a state of crisis. Apart from anything else, the chief focus of the CASAC report is OTC markets, and the whole Barings episode is, of course, exchange traded—and not exactly complex instruments—they are instruments even I can understand.

CHAIR—That is one of the points you made in your Terrigal speech: that one of the aspects of Barings was that it occurred on an exchange, rather than over the counter, which, in a sense, people would have been more inclined to expect, or be less surprised about.

Mr Cameron—Yes, but the complex aspect of Barings is the alleged arbitrage. He said he was arbitraging between two exchanges and it may well be that he was misleading his superiors and other exchanges, and so on, about that point.

CHAIR—The disclosure standards that you referred to, what is your timetable for developing this with the ASCT, the corporate treasurers?

Mr Cameron—It is now extraordinarily close. I had hoped I could tell you today that they were about to be announced or had just been announced. But it is that close. It could well be a day or so.

Senator SPINDLER—On that point of disclosure, bearing in mind what Mr Rodgers said about possible ratios of risk exposure as against capital base, and bearing in mind that you said we should not rush to say there should be a law against it, do you see any need to ask for disclosure of these ratios, perhaps as part of the continuous disclosure regime? Is that something that the ASC should become interested in, or do you prefer to step back from that?

Mr Cameron—I think the first way I should answer that is to say that the continuous disclosure or enhanced disclosure regime is in full force now. If there is anyone out there with a derivatives position that affects, in effect, the market value of their entity, their corporate or trust, or whatever it is, they should be telling us now.

The really difficult question, and what the Society of Corporate Treasurers guidelines are directed to, is what general information the market should have about what approach the corporates take to the use of derivatives altogether. In the *Fortune* article, for

example, one learns that Gibson Greeting, I think it was, had engaged in this complex set of transactions called a 'wedding band' about interest rates in order to save less than $1 million. But in order to save less than $US1 million, they had exposed themselves to unlimited liability if the interest rates went outside the band. I would hope that the guidelines that the Society of Corporate Treasurers is putting forward would sufficiently provoke management into setting internal guidelines as to what it was supposed to be doing with derivatives as to avoid such absurdity.

I think it is partly driven—and you get this flavour again from the *Fortune* article—by viewing the treasury operation of a corporation as a profit centre. I do not want to make that illegal but, when you do view the treasury as a profit centre, then you provoke the person running it to think in terms not only of how they can save money but how they can make money. It seems to motivate people to perform in odd ways.

Senator SPINDLER—Under the continuous disclosure provisions, could you please refresh my memory—what is the time scale within which reports need to be made?

Mr Cameron—My recollection is that it is three days. I should know that instantly, but I am pretty sure it is. The listing rule is the primary rule. It does not have a time in it; you just do it straightaway. But under the law you become in breach if you have not actually complied by the third business day, as I recall.

Senator SPINDLER—In view of the short time scales mentioned by Senator Gibson, should that be contracted?

Mr Cameron—I do not think it needs to be. I was involved to some extent in the debate with corporations about that time scale. The fact is that corporations do need time to ensure that people at the appropriate level have considered the implications as to whether it really does require disclosure and, if so, what disclosure; and then, whether the confidentiality carve-outs in the Stock Exchange rules are in operation or not. With all of that in mind, that is quite a short time frame. In a situation of rapidly changing interest rates or market upheaval, the enhanced disclosure regime may well cut in, but Barings gave us no such indication because there was nothing other than a trivial exposure of any Australian entity to anything that happened in Barings. There were some counter parties'

exposure in Singapore, we understand, but all at the level of trivia in market terms.

CHAIR—I just pick up a paragraph from your Terrigal speech over the weekend on over-the-counter. You said in that speech:

Nevertheless, I do not believe that is sensible . . . to leave these important markets, even the OTC market between professionals, unregulated and opaque. What is needed, and what the ASC has consistently called for, is a light touch of regulation—

this is one of your well-known turns of phrases—

in terms of disclosure requirements, and the exclusion of amateurs from a field best left to professionals.

It is the 'exclusion of amateurs' point I would like to ask you about. To what extent are you worried that in the OTC market there are amateurs there already, and how do you exclude them?

Mr Cameron—I am not sure that we have any belief that there are currently amateurs in the market. The difficulty is to define them. In the policy statement, we have attempted to formulate suggestions as to who ought to be qualified to conduct an exempt market and who ought to be qualified to play upon it. In that, for example, we have adopted, as one of the tests of a person who would be a professional, total assets of $10 million or more. That was a very deliberate choice of words and part of what drove that, for example, was that a requirement for net assets would be very hard to measure, but a requirement of total assets was deliberately designed to pick up the fact that, if you could persuade a bank or somebody else to lend you $10 million, if you were that clever, then you ought to be able to deal on these markets. It is the level of sophistication and the likelihood that you would acquire, if you did not already have them yourself, the skills and you would buy in the expertise to operate in the markets. We were not attempting to prevent large corporates, which are not otherwise subject to any prudential supervision, from being active players in these professional markets. It is up to them to protect themselves with appropriate corporate governance procedures and so on.

So we do not want to limit the professional market to banks and other prudentially supervised bodies like insurance companies. Rather, we want to have a test of size and ability—a pretty arbitrary test, but nevertheless intended to convey the idea that they would have the ability to buy in expertise if they did not have it themselves. You could

say that we set that above the highest level of any lottery prize that has yet been won in Australia. So if you can point to me a lottery winner with more than $10 million, we would change our policy. But I do not think it is appropriate for a fortuitous lottery winner to be able to go into that professional market. So we put it above that level.

Senator GIBSON—Could I just follow up. To go straight back to a point you made a little while ago, with regard to treasuries having incentives to make profits, having personally been a chief executive or chairman above treasuries that in fact have had incentives to do just that, and seeing how effective such goals are in making the treasury officers mad keen and enthusiastic and effectively working, I do not see how you can get around that problem except by proper controls on what they are actually doing. Having seen changes in groups that have been under my control from not having those incentives to actually having them, it is really chalk and cheese in the way they actually perform, and I would hate to see a regime whereby that was not allowed.

Mr Cameron—Let me hasten to say that I am certainly not suggesting things like that ought not to be allowed as a matter of law. Secondly, I am sure there is a case in various corporates for saying that you ought to do it that way. It is rather that the incentives, the messages that you send by allowing that approach, do create added tensions on the responsibilities of people who are dealing with the treasuries. That is the point in the *Fortune* article and I am merely quoting it. I certainly do not want to be thought to be advocating legislation. I would simply say that it increases the dangers and would require increased attention from management to ensure that it did not lead to—

Senator GIBSON—I agree wholeheartedly. It means that managers and directors have got to really make sure that they understand what the hell is going on and are not bamboozled by the jargon.

Mr Cameron—One of the advantages of people continuing to deal in futures traded things is that in exchange traded futures it is more likely management will understand.

Senator GIBSON—Yes.

Mr Cameron—I have a concern that OTC derivatives can become so obscure that

the chief executives and so on will simply not understand what their treasuries have done.

Senator GIBSON—Absolutely.

Mr HUMPHREYS—In relation to an item here in the *Australian* in relation to the Australian Stock Exchange announcing plans to impose tougher penalties on member firms for back to front trading and not checking properly and all that sort of stuff, what would happen if we had a Barings type collapse here in Australia? I see that they are saying that they are going to charge Mr Leeson. They are trying to extradite him to charge him with forgery. If that happened here in Australia, under our laws, who could be charged and would it be the directors of the company? Say that Leeson can prove that the directors of Barings did know all about this and they are as guilty as he, if that happened here in Australia do we have any laws that would enable us to charge the trader or the company directors with malpractice or whatever?

Mr Cameron—The difficulty in answering that question is that it is still really a bit unclear as to what did happen. I think one possibility is that the forgery charges that are contemplated relate to false entries in books as to who the clients were with respect to certain transactions. I have not seen any suggestion yet that Mr Leeson was lining his own pocket in any sense. I think, therefore, the forgery is like the charge in Australian criminal law of making a false entry in a book. It was those kinds of charges, for example, that were laid against the participants in the golden ring of—was this in your time?—currency speculation.

The charges that were laid were not forgery charges as we would normally understand it; they are false entry charges. I think that is what has happened here. If Mr Leeson was misleading his superiors, I do not think it is likely that anybody other than he would be charged. On the other hand, if the superiors were lax in their supervision, they may well find themselves in Australia subject to hearings as to their suitability to continue to be licensed. In other words, we might take action against them on the basis that they had shown themselves, at least for a time, to be unsuitable to be participants in the industry.

Mr HUMPHREYS—What I am trying to get at is: should we have the penalties

there to discourage these types of people from carrying on those transactions? Is there enough there now to be a deterrent? Could the Stock Exchange say it is going to bring in some new guidelines where they are going to get tough on the traders? Is there nothing there at the moment to deter people?

Mr Cameron—I do not think there is any lack of laws to deal with the traders, and I am not sure that I understand that there is a case for saying that the law needs to be made tougher on the directors, if you like, on the people who operate the trading companies. I am not sure whether I have answered your question completely, but that—

Mr HUMPHREYS—Just take the example of the state election where they are all going to get tough and it will be three strikes and you are in and those sorts of things. There is no deterrent there to really say, 'Well, if you are caught in this sort of trading, irrespective of who you are, then you are going to have a long sentence behind bars or whatever.' Should there be a tougher penalty to stop them even thinking about doing those sorts of things?

Mr Cameron—I think I would again emphasise though that this is an industry which requires you either to be licensed or to have an authority if you are in the securities area. And in all of those cases, if you are in fact an unsuitable person on a civil standard of proof, you will be excluded from the industry by the ASC. So, in a sense, the penalty that you might seek to impose for criminal conduct is one thing, but the exclusion from the industry would almost certainly follow, without having to prove unsuitability on anything other than a civil standard. It simply would be a question of suitability, and you would be out. So it is half a strike and you are out in the securities and the futures industry because it does not have to be proved to the point of a criminal offence. And I should say that it does happen. I have not come in possession of any of the recent cases, but there have been two life disqualifications from the securities industry in the last month, and there was a 44-year disqualification shortly before that, so it certainly does happen.

CHAIR—We might move from securities and Barings to a couple of other issues, but you should not take our small number of questions as being any sign of complacency

on our part.

Mr Cameron—No, it is my fault for having spoken too long really.

CHAIR—No, no. We had the benefit of a very comprehensive opening statement, for which we are very grateful, and that covered very many of the issues we would have raised with you.

The second issue I wanted just to touch upon quickly is the futures and securities amendment bill, which has just gone through the House. I take it from what you have said generally about Barings that you saw no reason for this bill to be held up, pending any analysis of Barings?

Mr Cameron—Certainly not. I do not think there is anything that we have seen to date out of Barings that would throw any doubt upon what is proposed, which basically is that, under this regime, the product will be the subject of regulations which will define it, and there will be business rules and so on, and the commission and the Attorney-General will be involved in a process of approving all of that. And an appropriate hybrid regime will be constructed out of chapter 7 and 8, which will ensure that the appropriate level of investor protection is available for these novel, unique products.

CHAIR—When Mr Hosking was before us earlier this month, he was making reference to this area, and he said, when referring to the bill:

It has now been indicated to us by the Australian Securities Commission and the Attorney-General's Department that in place are a number of rules and requirements at ASX level that will at least simulate our level of regulation. We do have the concern I mentioned—

this was concern he referred to regarding the first amendment bill that was put in—

that it is still basically voluntary as opposed to embedded in chapter 8.

He expressed the view that the chapter 7 requirements were voluntary and the chapter 8 requirements, in a sense, were compulsory. In the course of his opening statement before us earlier this week, Mr Humphry from the Stock Exchange, hotly disputed this. I am wondering whether you had a view on that.

Mr Cameron—Yes. Unfortunately, I did not become aware of his use of the word 'voluntary' until too late to ask him myself what he meant by that. I would not, in any sense, have used the word 'voluntary' to describe the regime. What will happen is that

regulations will be enacted which will apply the relevant provisions of chapters 7 and 8. Once that has happened, those regulations will not be voluntary in the slightest. They will have the same force as the current chapters 7 and 8 have with respect to the products they regulate. The only way in which I can understand why he used the word 'voluntary' is that, in a sense, it will be the Stock Exchange, presumably, that will initially propose what the regime will be. Once the Stock Exchange has done that, it will be enacted by way of delegated legislation and will have the full force of law. I was not aware that Mr Humphry had said anything about it, but I would have a difficulty in seeing why he would call that voluntary.

CHAIR—The second point I put to both Mr Hosking and Mr Humphry was that we have gone down this road of the amendment bill to basically create the hybrid regulation for what we are seeing as hybrid products, given the definitions that you find in the separate chapter 7 and chapter 8. It has always struck me that rather than worrying about definitions we should simply make sure that we have got the regulatory regimes and the prudential requirements in place, which give you an infrastructure, and then basically say to the various exchanges—the SFE and the Stock Exchange—that they can trade in whatever products they like subject to these underlying requirements being met. Do you have a view on that?

Mr Cameron—I certainly think that it will be possible under this legislation to construct the appropriate regulatory regime for the individual products whoever is trading them. There is no doubt that the characteristics of a futures exchange are inherently risk oriented in a way that a securities exchange is not. But these products—the proposed share ratios—do have mixed characteristics because they do, after all, relate solely to what is happening on the equities market but they also have the characteristics of futures. I do not see any reason to think that it will not be possible to construct an appropriate regime by way of regulation for them.

Mr Rodgers—The other thing to add to that is that the ASC's report, which was really one of the things that stimulated and has focused the CASAC review, has made suggestions about what a regime might look like in the future and it does suggest that

there are substantial opportunities for simplifying the legislation and making it both more rational and more even handed in the way that it applies. Part of that does apply to doing away with distinctions that are currently maintained in chapter 7 and chapter 8 and saying that there is no need for regimes which are substantially the same to be set out in different chapters. The suggestion you make is one that generally the commission has suggested should be thoroughly explored in the law reform review process.

CHAIR—The CASAC review process?

Mr Cameron—Yes. Also, in any event, it will come up in the simplification process because at some stage the Attorney-General's simplification program will reach chapters 7 and chapter 8.

Mr SINCLAIR—I have not been here so I do not know whether you have covered this. One area that had me a little concerned when the SFE was before us was the extent to which there is no communication between futures exchanges. I know that is outside the strict bounds of your responsibility, but it struck me as incredible that there can be somebody operating beyond the limits that are set by your exchange—although not necessarily of an area that is notifiable in the exchange where they are operating—and that that particular individual could put that exchange at risk because you do not know of the parallel liability. Is that an area that you have examined? Have you any views or comments on it?

Mr Cameron—I suppose it is impossible to give you an absolute assurance that that cannot be a problem. For example, I think you used the expression 'an individual' but, if in fact a corporation is trading under different corporate identities, it can be very difficult to be sure, whether you are the self-regulator—the exchange—or the government regulator, that you have got the full picture of what the exposure of that corporation in its wider sense might be. Certainly, though, the better regulated exchanges have frequent contacts with each other at an informal level. They do have these industry meetings two or three times a year, and the government regulators usually attend in some guise as well. Because they are usually held in Europe and America, we do not get there all the time, but we do try and go at reasonable intervals ourselves. But basically I would think—

Malcolm might like to respond too—that it would really depend upon the individual examination by the auditors from the exchange of what is happening in the member, would have to be pretty assiduous to track that down. Getting absolute assurance, I think, would be impossible.

Mr Rodgers—There are some proposals being discussed between the American exchanges which, it seems clear, if they come to fruition, the Sydney exchange would want to be involved in. For example, there are discussions between the various clearing houses for the American exchanges about multilateral netting off of obligations so that a participant in the market does not have a series of—

Mr SINCLAIR—Exposed positions.

Mr Rodgers—Exposures. From an industry participant's point of view, they should not have money tied up in a whole series of clearing houses when the net result of those positions would require less funds employed. It does seem clear that some more formal arrangements between series of clearing houses will emerge at some stage in the relatively near future. I think that it is more than possible that the Australian exchange will be part of that set of arrangements, because there is very substantial trading on the Sydney Futures Exchange by American participants. Nobody is quite sure; I think the SFE's estimate is that somewhere between 15 and 20 per cent of trading on SFE on a regular basis is US in origin. So it seems to me that if the American exchanges and clearing houses do work out multilateral netting arrangements, which, of course, gives the self-regulatory part of the industry an overview of what is going on with individual participants, that will go some way to addressing the kind of issues that you raise.

Mr Cameron—That leads me to comment that in our five-year strategic planning we address all sorts of issues about what might happen in the future. We do not yet have, even on a five-year time zone, a global regulator. But, if I was doing a 10- to 15-year time zone, I would say that consideration of a global regulator will be on that time line. It will not happen in 10 to 15 years but it will be clearly an issue by then.

Mr SINCLAIR—A global regulator raises other—

Mr Cameron—I think it is a logical corollary—

Mr SINCLAIR—Yes. But exchanging information seems fairly basic. But I can understand 10 or 15 years.

Mr Cameron—Yes. That is all I am saying, that I think in that time frame you would expect that that must start to become an issue. Very difficult, but people will be thinking about it.

Mr SINCLAIR—Thank you.

CHAIR—Just a couple of questions on corporate governance. We had the Stock Exchange here earlier in the week and Mr Humphreys gave us an update on where the exchange is on corporate governance. You probably recall the discussion paper the exchange put out in the last quarter of last year which basically recommended the Cadbury code model of a prescribed list of corporate governance practices and, where you have not done something to apply yourself to that, you have got to indicate why you have not complied. Mr Humphry on Monday advised us that the management was putting to the board yesterday a formal recommendation which was different from the proposal contained in the discussion paper, basically a listing rule which would require listed companies to generally indicate what corporate governance practices they had adopted and a schedule to the listing rule which would give an indicative list of corporate governance areas but with no prescription either in terms of the list or, if you have not done anything, please explain why.

I expressed some concern to Mr Humphry that I saw a couple of problems in this: firstly, a perceptional problem as there is a substantial diminution from their earlier starting point, as a domestic perception; and, secondly, given that the Toronto Exchange has adopted a Capri model as well, we might find ourselves falling short of international best practice. I understand that yesterday the board resolved in principle to adopt the management recommendation, but did not formally adopt it pending further consultations with the parties who might be concerned about this area—whether it be the parliamentary committee or the Attorney-General or anyone else. Do you have a view of these matters?

Mr Cameron—I have not seen what the Stock Exchange has done either. Like you, I had the benefit of a preliminary conversation with Mr Humphry, but I have not

otherwise seen what they have done. In answer, therefore, I will say—and, in fairness to them, I should not comment too specifically—that the philosophy that these matters of corporate governance ought to be matters fundamentally of disclosure according to some standard, rather than prescription, seems to me to be not an inappropriate way to go. Just how you do that, as a matter of detail, I am not sure.

The problem about prescribing them is that the circumstances of the 1,100 listed entities on the Australian Stock Exchange is simply so different that you run the risk that if you only apply them, for example, to the large companies, you create a sort of impression that the smaller companies are not any good because they do not comply with them, whereas the reality is that they simply are not appropriate to them. So I do see disclosure, and investors then making up their own minds as to whether they want to invest in companies that do not happen to have nomination committees or whatever, as an appropriate way to go.

We do have in the law and, to some extent, in the listing rules some quite specific matters of corporate governance and I think they are appropriate to deal, for example, with related party transactions, the use of a company's funds to support purchases of shares. They are all really corporate governance issues, and even a lot of the audit requirements are corporate governance issues. I have no problem with those. But a lot of the things that are now being talked about as matters of best practice for corporate governance are matters upon which views can differ and where there will be continuing change, in any event, and having some degree of flexibility and a disclosure based regime seems to me to be appropriate. Certainly, the commission has had no desire to launch into a suggestion to you or to the department that there should be some wider level of prescription in this area. If the exchange has moved in some direction towards better disclosure in this area so that people can make up their own mind, that is likely to satisfy most of our concerns.

CHAIR—I tried to give Mr Humphry a bit of comfort by quoting you back to him.

Mr SINCLAIR—And you are now going to quote Mr Cameron back to Mr Humphry!

CHAIR—You are quoted in the *Financial Review* of 26 October 1994 warning that:

. . . any move to formalise corporate governance issues should steer clear of the 'checklist mentality' that can evolve in a business environment.

'I have yet to be convinced that operating by way of a series of prescriptive checklists facilitates good business in any respect,' he said.

Mr Cameron—I certainly believe that, to this day. But what I get worried about is that people then start worrying about the form and not the substance and, in a sense, you cannot escape people having to think about the substance of what they are doing.

Senator GIBSON—That is the difference between the company that has net assets worth, say, $10-50 million compared with the 50 leaders—just chalk and cheese.

Mr Cameron—That is my problem. I see enough of the smaller end of the listed company market to think that a lot of the things that are being talked about are simply inappropriate. In fact, from my own experience of some of those smaller companies, those rules are simply not going to work.

CHAIR—In your Terrigal speech, you said:

This focus on the principles of sound corporate governance extends to all corporations and their directors, but especially to those 'top drawer' companies that are the custodians of a great deal of the nation's savings, and also act as role models and set standards by which other corporations will operate.

I got the impression from Mr Humphry that, while in numerical terms the responses they had had to their discussion paper were 80 per cent in support and 20 per cent opposed, the qualitative assessment was that it was the top 10 or 20 corporations that were causing the management most grief—if I could use that pejorative phrase—in terms of trying to get a proposal moving forward.

Mr Cameron—Yes; in fact, my comments about the top drawer companies, although they extend to corporate governance, were actually being made for a slightly different reason. They were about our enforcement activities with respect to those companies, rather than about their corporate governance—although it obviously does extend to that.

CHAIR—It was the role model point that I wanted to make.

Mr Cameron—Yes; the role model point is quite genuinely meant. Not only

should they not have any belief that they are exempt from our surveillance but also they ought to set the best possible example for the other end of the market.

CHAIR—They are also the ones who are most able to satisfy whatever regulatory requirement there is. In the exchange's discussion paper, there are the three tiers of reporting requirements, which are basically driven off the fact that not all companies are the same, and that the burden that you place on a top 10 or top 100 company may well be a burden that crushes a listed company at the bottom end of the scale. So there is a genuine need for there to be mixing and matching.

Mr Cameron—Yes. That would explain why the Stock Exchange has such difficulty with making these things prescriptive: the top end of the market that does not need to have them prescribed does not want them prescribed, and the bottom end of the market is either going to do them anyway or is not going to. If they decide that they are not interested in attracting investment from people like the members of the Australian Investment Managers Association, then they will not bother to comply; but that is their deliberate choice, as I see it. It is very hard for a bureaucracy to be created to administer that.

CHAIR—Absolutely. Again, not showing any air of complacency, we have exhausted the issues that we wanted to raise with you today, which were primarily derivatives and post-Barings matters. We thank you very much for your comprehensive opening statement, Mr Cameron, and we also thank you and your officers for your attendance today. These public hearings are important, as part of the general oversight of both the Corporations Law and specific issues when they arise. We look forward to further regular contact with you, and we will no doubt speak about these matters by way of public hearing again in due course. Thank you all very much.

Committee adjourned at 1.50 p.m.