**COMMONWEALTH OF AUSTRALIA**

# JOINT COMMITTEE

on

## CORPORATIONS AND SECURITIES

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

**CANBERRA**

**Thursday, 30 March 1995**

**OFFICIAL HANSARD REPORT**

**CANBERRA**

JOINT STATUTORY COMMITTEE ON CORPORATIONS AND SECURITIES

Members:

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

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| 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.

## WITNESSES

**HALL**, Mr Leigh Loddington, Member, Companies and Securities Advisory Committee, 60 Margaret Street, Sydney, New South Wales . . . . . . . . . . . . . . 2

**KLUVER**, Mr John, Executive Director, Companies and Securities Advisory Committee, 60 Margaret Street, Sydney, New South Wales . . . . . . . . . . . . . . 2

**LONERGAN**, Mr Wayne Richard, Member, Companies and Securities Advisory Committee, 60 Margaret Street, Sydney, New South Wales . . . . . . . . . . . . . . . 2

JOINT STATUTORY COMMITTEE ON CORPORATIONS AND SECURITIES

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

CANBERRA

Thursday, 30 March 1995

Present

Mr Stephen Smith (Chair)

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| Senator Cooney | Mr Humphreys |
| Senator Gibson | Mr Sinclair |

The committee met at 9.49 a.m.

Mr Stephen Smith took the chair.

**HALL**, Mr Leigh Loddington, Member, Companies and Securities Advisory Committee, 60 Margaret Street, Sydney, New South Wales,

**KLUVER**, Mr John, Executive Director, Companies and Securities Advisory Committee, 60 Margaret Street, Sydney, New South Wales, and

**LONERGAN**, Mr Wayne Richard, Member, Companies and Securities Advisory Committee, 60 Margaret Street, Sydney, New South Wales,

were called to appear before the committee.

**CHAIR**—Good morning, ladies and gentlemen. I welcome the members and executive director of CASAC, the Companies and Securities Advisory Committee, to this public hearing of the Parliamentary Joint Committee on Corporations and Securities. I am pleased to note that this is the first public discussion the committee has held with CASAC for a number of years pursuant to the committee's role in overseeing Australia's companies and securities law.

The principal purpose of this hearing is to discuss with CASAC Australia's current legal and regulatory approach to derivatives trading and investment, and CASAC's paper *Law of derivates: an international comparison*, published in January, a month or so prior to the Barings Bank collapse. I understand, Mr Hall, that you have an opening statement for the committee which you would like to speak to. Is it the wish of the committee that the document be incorporated in the transcript of evidence? There being no objection, it is so ordered.

*The document read as follows—*

**Mr Hall**—I will just highlight some of the aspects of our statement. We started work on our review of derivatives in the middle of last year. This was prompted by the rapid growth in volume and complexity of the Australian derivatives market. Our task is to ensure appropriate protection for on-market and over-the-counter participants while encouraging the benefits of an innovative and internationally competitive Australian derivatives market.

To assist the review, the advisory committee established an expert advisory panel drawn from the Sydney Futures Exchange, the Australian Stock Exchange, the Australian Securities Commission, the Reserve Bank, other banks, merchant banking organisations, lawyers, accountants and academics. A full list of these is attached to our statement. We have also established a netting subcommittee, and a list of its members is attached. Each of these committees has met three times.

We are all very much aware of the much publicised losses that have occurred offshore, and we are aware that this has led to a poor public perception of derivatives. However, they can be very useful, albeit complex, financial tools. By way of explanation, there are two important uses of derivatives. The first is to provide a form of insurance—for example, to protect an asset or minimise a liability against fluctuating market values, whether commodities, securities or currencies. This is the typical hedge contract which provides certainty in a volatile world. The other use is to allow a very cost-effective way to acquire a change in exposure to an asset class. This is particularly the situation in fixed interest markets, where the liquidity and low cost of transaction is of immense benefit to all participants.

We do not see it as the task of the advisory committee to attempt to eliminate the risks inherent in derivatives or to counter the consequences of poor investment strategies. Indeed, we would be concerned that any industry based initiatives or regulatory response in Australia should not intentionally or inadvertently encourage the view that the real financial risks associated with derivatives have somehow disappeared or been minimised. The advisory committee notes and endorses the comment of the ASC chairman Alan Cameron that it is impossible and undesirable to guarantee that a Barings type disaster

could not happen in Australia. Rather, the advisory committee plans to recommend a means of better conducting both the exchange traded and over-the-counter derivatives markets.

Of course, the protection of end users is something that is going to be foremost in our minds, and this will have particular reference in the over-the-counter market. I think it is inevitable that at some stage over-the-counter products should be made available to retail customers, because there will be uses that they can put them to. We have also noted the discussion paper put out by the ISC and we certainly support the moves taken there. We see that having a risk management statement is a useful form of disclosure that should help manage and eliminate risks in that area.

Market volatility and contagion are an important issue, and some commentators have raised concerns as to whether large scale derivative activity could unduly increase the level of volatility of financial markets, particularly through option trading. There is no evidence of which we are aware that Australian markets have suffered from undue volatility in the face of an underlying asset or index of commonly traded derivatives. Indeed, the advisory committee is aware that derivatives may well reduce volatility and will provide for certainty, which is necessary to encourage economic development. Just by way of example, the use of forwards markets is a very useful tool for a large number of corporates and other participants in making certain what their revenues or exposures will be.

Counter party credit risk is an important issue, and of course in the over the counter markets there are naturally no clearing house facilities or compensation funds. So there is the risk to those counter parties and that is why in Australia to date such markets have been available only to professional users. Some of the counter party risk can be reduced in various ways, including collateral agreements and effective netting arrangements. Netting allows the fair value of offsetting contracts between customers to be balanced against each other, and master netting agreements provide for offsetting of all contracts between the parties and contemplate a single payment in a single currency between those counter parties in the event that a default under the agreement occurs.

We have set up our own subcommittee, which is the netting subcommittee. Much of the work there is being done by Bob Austin of Minter Ellison, and it is has produced a draft report at this stage that should be finished by the middle of this year. It will deal with bilateral close out netting, on market netting and transactions involving trusts. We believe this is going to be something which will provide a very real benefit to the markets, and it will be useful that this report be considered in conjunction with the current Reserve Bank proposals regarding payments netting.

Capital adequacy is also an important issue, and the Basle accord of 1988 imposed various capital requirements on banks in respect of their derivatives transactions. The advisory committee will be giving consideration as to whether any capital adequacy requirements should be imposed on other participants in over the counter derivatives markets and the form that they may take, and will be looking as to whether the capital adequacy requirements would perform the various functions, such as evidence of commitment, that is, the hurt money, evidence of capacity to operate in the market skill money, providing a limited pool of funds for counter parties, which is comfort money.

Transparency is also very important, and this can be covered under the headings of risk management and of disclosure. The Barings collapse raises again the question of the capacity of market participants to monitor, verify and control the risks incurred by their internal dealers or corporate treasuries, and excessive risks may arise if those risk parameters have not been properly set, risk limits are too permissive or too easily breached. We will follow up on the recommendation of the Basle committee and IOSCO, which have made a number of recommendations.

On disclosure, we are very supportive of all the efforts that are being made to improve upon disclosure in this area. We note and endorse the joint proposal of the ASC and the Australian Society of Corporate Treasurers to introduce an improved system of derivatives disclosure and note the similar proposals of the ISC discussion paper that has just been released. We recognise that there will be some who will oppose a statutory enhanced disclosure regime but it is one of the things that we certainly will need to be looking at.

One of the things that we will be giving quite a bit of thought to is whether we do need to have external control or whether it can be done in a self-regulatory manner and in all those one has got to be trading off the costs of the various alternatives. Certainly, we must avoid the bucket shops and other excesses that were evident in the early part of the last decade.

So there is quite a large range of issues that we are looking at, but we believe that we will be coming forward with a series of recommendations which will properly weigh up and then balance the various considerations as against protection on the one side and undue hindrance of a very necessary market on the other.

**CHAIR**—Thanks very much, Mr Hall. Your full opening statement, which we have incorporated, has been circulated for members, so thanks for that. I have a couple of questions but a comment first: with the work that you published in January 1995, I must compliment you on your choice of your first paragraph, which I have used publicly and in the House on a number of occasions.

**Mr Hall**—You have sinned!

**CHAIR**—I will not repeat the quote but it is a great quote. I think the serious point behind the quote is that we are dealing here with a highly technical subject matter, and your work in a sense as the technical committee would be very relevant to the policy responses that you get from government and the parliament. The follow-up to this study, as I understand it, is a discussion paper later in the year and a final report subsequent to that. What is your timetable for completing your effort in this area?

**Mr Hall**—We would certainly want to have the discussion paper out in the middle of the year and, following comments upon that, to have our final report completed by the end of the year.

**CHAIR**—Do you think that is an appropriate timetable, given the climate post-Barings?

**Mr Hall**—On the one hand, we have given thought to whether it could be speeded up, and certainly we are going to expedite it. On the other hand, it is such a serious issue that it would be very remiss of us to hurry it just to react to something such as Barings.

Actually one of the benefits, if you like, of the Barings issue is that it is really causing everybody, everywhere, at every level, to be paying particular attention to this whole derivatives issue. I think that is going to be very advantageous and, as a result of people focusing on that, it is going to be of further assistance to us in our work.

**CHAIR**—I think that is right. Without wanting to speak on behalf of the committee, I have certainly had the impression in the public hearings that we have had with the Sydney Futures Exchange, the ASX and the ASC, that everyone has used it as an alarm bell to go through all their various procedures to ensure that we are better than up to the mark, that it has caused that response.

I see you pick up Alan Cameron's comment that it is impossible and undesirable to guarantee that Barings cannot occur in Australia. He got that out in his opening statement yesterday to avoid the question which I had put to the SFE and the ASX as to whether they could guarantee it. But I must say that, in a sense, it was a trick question because if the answer had been yes, then one would have had cause for concern. The answer being no, that it is about making sure that the risk is minimised, actually gave me some confidence that we might have in place effective risk management regimes.

You then went on to make the point about the difference between risk hedging, which is the historical birth of derivatives, and pure speculation. To cover the pure speculation I note that every piece of legislation that involves futures or derivatives has the provision about the operation of the state gaming and wagering provisions. To what extent do you see a move to pure speculation as also carrying with it the need for further regulation or more regulation?

**Mr Hall**—I wonder if I might just clarify what I meant to say. On the one hand, you have got the hedge contract which is really the insurance contract. This is the thing that brings certainty and I do not think there can be any argument that that is not a good thing.

**Mr Lonergan**—They are enormously beneficial to the capital market or industry generally.

**Mr Hall**—The other beneficial use of derivatives is that it is an alternative to

buying the actual asset. Where it is of benefit doing it this way is that, quite often, there is more liquidity in the derivatives market and certainly there usually is far less cost—not just because of the monetary outlay—but far less cost in terms of the brokerage, stamp duties and other transaction costs.

For example, if I, as an investment manager, want to buy some 10-year bonds, it is much cheaper for me to leave most of my cash in the bank earning interest—buy some 10-year bond futures rather than go out and buy the actual 10-year bonds. The differential in cost is very marked. It would be a real pity if those types of benefits were taken away from market participants. The important thing is that there be the prudential control to make sure that if it is an investor, for example, with a superannuation fund where there is a fiduciary responsibility to the members, then there should not be any risks by leveraging the fund up. That is an absolute no-no.

**Senator GIBSON**—On the point you have just made about buying the future rather than the actual bond, I am just wondering, for the benefit of committee members who are not experienced in doing such things, could you put some numbers on the differentials that currently apply?

**Mr Hall**—No, I am sorry, I cannot. It is a long time since I have actually done it myself. But the factor of dealing in the physical would be a function of several times. The other factor is the—

**Senator GIBSON**—You are talking about transaction costs?

**Mr Hall**—Yes, in transaction costs. The other thing is just the liquidity, that a number of these markets—especially the fixed interest markets—are exceptionally liquid. You would sometimes have difficulty in transacting the same volume in the physical market. In effect, by transacting in the fiscal market, you would actually create more market volatility than by acting in the derivatives market.

**Mr Lonergan**—As a broad guide, if you took $1 million purchase of equities, your transaction cost would be something between one and two per cent depending on how you did it. So you are talking $10,000 or $20,000. If you executed the same contract through a share price index, you would be talking transaction costs that might run in the

low thousands or perhaps in the hundreds of dollars, so it is big numbers.

**Senator GIBSON**—Thank you.

**Mr Lonergan**—That is the order of magnitude you are dealing with.

**Mr Hall**—Yes, in the share market it is a more marked difference, although it would depend on the premium. But in the fixed interest market, it is still quite sizeable, too.

**CHAIR**—You referred to the inevitability that over the counter derivatives would be made available to retail users. I am just wondering how that sits with a comment that Alan Cameron made in a speech on the weekend, effectively repeated to us yesterday, where he said:

> Nevertheless, I do not believe that it 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, in terms of disclosure requirements, and the exclusion of amateurs from a field best left to professionals.

This applies particularly to the OTC area. It was his reference to excluding amateurs from that field best left to professionals, and your comment that OTCs inevitably been made more available to retail users. Do you see any conflict between—

**Mr Hall**—I do not disagree with what Alan says and, certainly, I do not think one can ever argue against there being adequate disclosure—sunlight is the best disinfectant, as they say. It would be unwise to be allowing unsophisticated retail investors to get themselves caught up in areas which were not properly supervised. But I think that, eventually, it would be unfair to deny individuals opportunities for making certain types of investment or arranging their affairs in certain ways.

Now I do not want to predict just where markets are going to go, but it may well be that it would be unfair not to allow an individual to buy a product, say, that might have the effect of capping the interest rate on their home loan. That is the type of product that is available in the professional market. Yet I think you could reasonably argue that such a product, if properly supervised and everything else, should be available to the ordinary person. I just use that by way of illustration.

**Mr Lonergan**—Perhaps the distinction is between hedging and dealing. Taking

Leigh's example of individuals who want to insulate themselves against the risk of rising interest rates on their home mortgage, that is more or less a hedge transaction. It is protecting themselves. It is just a form of insurance. However, the same individual, as an amateur, should not be out there dealing in derivative actively, that is, selling such products. That is an entirely different step in it. I must say my view is perhaps a little stronger than Leigh's—that it would be inappropriate to exclude people, subject to normal disclosure requirements, from protecting themselves, and in a day to day sense very many people use them for just that reason.

**CHAIR**—The final one I had before handing over to the deputy chair was just the chapter 7, chapter 8 distinction. Two areas where we have seen that cause difficulty or dispute are the LEPOs case between the ASX and the SFE and the securities and futures amendment bill, which went through the House yesterday. This is a point I have put to just about everyone we have seen.

It struck me that we seem to be having this sort of highly technical discussion about definitions when the best way to solve the problem simplistically is to come at it from the other end, which is to basically have the ASX out there essentially trading in securities but moving often to new products and the SFE essentially trading in futures and derivatives but developing new products. You would then have one chapter or one basic infrastructure which gives you your prudential requirements and your regulatory regime, which protects investors as best you can, and then you allow the two exchanges or any future exchange that might be developed in Australia to deal in whatever products they like, subject to that regulatory and prudential infrastructure being in place.

**Mr Hall**—That is certainly something that the advisory committee is paying quite a lot of attention to and, clearly, after the full court decision in the ASX-SFE case, it has actually left quite a few loose ends so that you have the situation now of a number of the derivative products, which are not covered in the legislation, and then you have some other transactions which would appear to be covered under both chapter 7 and chapter 8. So this is something that we have had quite a clear focus on right from the start of our exercise, and everybody recognises, I think, that it is something that needs to be fixed.

Certainly, our discussion paper when it comes down in the middle of this year will have proposals in it as to how that should be dealt with.

**CHAIR**—We are relying on you to fix it.

**Senator GIBSON**—Coming out of the Barings fiasco and knowing that the traders can take positions in a very short period of time, are you giving due consideration to how we can have an effective exchange of information between exchanges with regard to exchange traded derivatives about positions taken by entities in various exchanges?

**Mr Hall**—It is an issue that we are aware of but it is not something that we have paid particular attention to at this stage. Where it obviously becomes very difficult is when one is dealing with the cross-border situations because, from a regulatory legislative point of view, it poses those very obvious difficulties.

**Senator GIBSON**—Is it likely to be a matter you would take on board?

**Mr Kluver**—Certainly, we are aware of the problem about disclosure, and the recognition, both in Australia and internationally, that accounting principles often just do not respond with the necessary speed with which derivatives develop, and there are some proposals to suggest an enhanced disclosure system so that the market is more fully informed of the positions of people in a manner which is more relevant to derivatives rather than, as I say, after the event type disclosure.

I think the important point to note here is that the most recent initiative, which came out of the latter part of last year, is a G10 central banks initiative. So this matter is being looked at internationally, and also the SFE and the ASX have indicated their recognition of this particular problem.

**CHAIR**—Thank you.

**Mr HUMPHREYS**—I was just interested in a program last night on the TV with computer hackers and the ability to fraud with all this new technology. I was thinking of the advisory committee looking into the future of that and how we could best handle that because there could be a situation where some of these traders and some of these geniuses with their new technology could put false information through, and you would never catch up with it until the company was finally bankrupt or whatever. Is there any role that you

can play on that as an advisory committee, because it seems pretty alarming to me how easily people can create fraud? If you just take Social Security where some people working within the department can use their computers to hide their thefts for quite a while even though you finally catch up to them, is this situation likely at the Futures Exchange or the Stock Exchange?

**Mr Hall**—That is not something that we have looked at as such, but as part of the ensuring that those people who are involved with these products have got the right systems in place, the security and integrity of those systems should be such that hacking would be difficult and if it has occurred it would be disclosed. In any event, the marking to market daily or, even more frequently than that, the separation of functions between the back office and the dealers in the front office are things which should assist in bringing out any illegal tampering with the records of any participant. Wayne, this probably comes into your field somewhat.

**Mr Lonergan**—Historically, the frauds in the area have not been technology frauds so much as dealers acting cooperatively, often around the world, passing through transactions, with the benefit of hindsight as to rate changes or to the disadvantage of their employers on a collective basis. That has occurred, and there have been a number of court cases and the people who are players are aware of that risk and deal with it as best they can.

If you are dealing with an SFE type situation then one would need to basically simultaneously hack into both the SFE system and the SFE's member system, otherwise one or other of those two systems would catch you out. So there is a degree of strength there. Having said that, in an OTC system it can happen. It is a fundamental internal control problem, the same as any other internal control problem; it just happens to be in derivatives where the numbers are potentially very large.

**Mr SINCLAIR**—One of the interesting parts to me is the range of matters that you have been reviewing. On an aspect of control—it is not peculiarly derivatives and in that field—it seemed to me that a lesson from the whole of the Barings collapse has been the extent to which trade conducted overseas beyond the outside jurisdiction is a matter

which becomes more difficult to control and regulate within the place of principal register. I do not know whether in any of the inquiries you have made you have looked at that subject, in other words, the degree to which you get a BHP or a CRA spending more and more of their resources outside Australia. That must put at risk the security of the asset within Australia. While there are obligations to disclose, that is probably not as adequate a disclosure in the sense that often the manner of operations abroad is different to the manner of operations and the way in which things are done within jurisdiction. I do not know whether you have got any observation to make, but it is an area that occurs to me as being one of the lessons of the Barings collapse, where the negotiations were said to be carried on outside jurisdiction.

**Mr Hall**—As far as financial institutions are concerned—and that is perhaps where, by the nature of their activities, it is more likely that something could occur in some other part—one is reliant upon the prudential controls of the home regulator plus whatever other controls there are by the regulator in the other parts where this institution is operating. Certainly the regulators are now cooperating more than they have ever done before on an international basis, although we saw a breakdown between Singapore and Japan with the Barings situation. You mentioned the case of a couple of corporates by way of instance. That, I think, is more a question that there be proper disclosure in the home market. That is certainly something that interests us, but again I will ask Wayne to comment. Amongst other things, Wayne is a member of the Australian Accounting Standards Board, and so this is an area that is very close to him.

**Mr Lonergan**—In partial answer to your question, there is a saddening similarity between what we know about Barings publicly—because a lot of it still is not known—and former losses incurred in not terribly dissimilar situations. The foreign exchange loss of AWA, which was a cause celebre here in the late 1980s and which I happen to have investigated at the time, bears many of the same internal control problems and other hallmarks of Barings. The particular situation that you referred to is fundamentally a control problem and a front-office/back-office problem, exacerbated by the distance between where this operation was and head office. It is an issue fundamentally of

corporate control. If they set up a branch office, they are obliged in accordance with normal procedures to have appropriate controls. If they do not, then a Barings situation can develop.

**Mr SINCLAIR**—I think that is true. I was really going beyond, and thinking of a Skase type situation, or a number of the other instances where assets have been transferred out of jurisdiction and the parent jurisdiction is left lamenting with no capacity to pursue individuals or access assets. I do not know whether there is a reasonable form of control that should be introduced. I have made this observation, for example, regarding superannuation funds and the degree to which, if you are going to address outside jurisdiction, you can have the same control: are you going to put those superannuation assets beyond the disciplines that required in terms of investing superannuation funds within Australia? I do not pretend it is an easy answer, but it seemed to me to be a matter to which there needs to be at least some consideration given. At a government level, in the Skase instance, we have demonstrably not been able to return him to jurisdiction; and it has happened in other instances.

Where you have major investors, to a degree, whether it applies to a Connell or a Bond or otherwise, there is always the suspicion that it does. It seemed to me that perhaps there might be an obligation imposed in accounting standards rather than at a legislative level. It is demonstrably something that is a problem for you as a receiver. I presume that is the function you exercised. In the AWA case it was not receiver, it was investigator; but whatever the form is, there a problem in trying to pursue assets out of jurisdiction. I wonder whether you can suggest ways in which we might need to either change the law or perhaps change accounting standards to require that greater disclosure.

**Mr Lonergan**—Can I deal with the accounting standards issue first. That one is perhaps easier. The Accounting Standards Board is about to go public with an exposure draft, which is a preliminary accounting standard put out for public discussion, on financial instruments. For reasons of international comparability, that basically follows the international accounting standard down the same track. However, as an add-on to the international requirements we have included a requirement that corporates discuss what

their risk exposures are, what they have hedged and what they have not hedged. That might sound rather simplistic, but the international standard only says, 'If you've hedged something, disclose that.' A number of us at the board—myself in particular—believe that the real issue is the risk that you are dealing with, not that part of the risk which you may happen to have hedged. It is a much bigger issue. Having said that, the difficulty with accounting standards is that they are pinpointed to annual results and a balance sheet at one point of time; and a day later or a week later that position can change quite materially. It is a big step forward, however, just to get corporates to identify their risk in a sensible way and to disclose it—going back to Leigh's point about the dose of sunlight.

The other issue which is difficult in an accounting standards sense is that there is a surprising corporate reluctance to mark to market in their accounts. They do it in their own internal management—or they do if they are in any way competent—but there is still a lot of corporate resistance to it, so it will meet some headwinds. But that will not just bring us up to international standards but, in fact, if this proposal gets through due process, we will be ahead of international standards—which, given recent events, would be no bad thing. At best, however, the accounting standards issue is a partial solution; it is just a point in time.

Going back to gaining access to people who have committed some misdemeanour in another jurisdiction, that is a tough one.

**Mr SINCLAIR**—It was not about gaining access to them but knowing where the assets are, particularly with the capacity to use a screen and transfer funds so quickly and without a physical transfer in the old sense. It is the obligation to disclose. I can see that tracing the individual is a different substance. But having reasonable knowledge of where the assets are and where they have been placed seems to me to be of interest to a group of people who at the moment probably have no access to that information. I do not know whether there is a way that something should be done about it. In the Skase instance, and I use Skase only because he is more recently in the news—there have been suspicions in many others—there is a problem of knowing where assets have been taken out of jurisdiction and what has been done with them.

**Mr Lonergan**—At a practical fraud level, if I can use that term, the probability is that it will not be so much the corporate assets that will not be able to be traced. Those corporate assets will, in all probability, be lost, a la Barings. The money will be gone. What would be desirable to be able to get at is where a dealer has some other back-to-back arrangement so that the corporate employer has lost and they have benefited. It is getting at that part of the asset trail which is extremely difficult. Because these things are often back-to-back, sometimes with cooperation, it is very hard to find. I am sorry, it is an incomplete answer to the problem.

**Mr SINCLAIR**—I was really wondering whether you were looking at this at all. I know you have a number of inquiries afoot. You tend to be pro-active in most instances, I suspect, rather than reactive, and this seemed to be an area where there might well have been some work—

**Mr Hall**—No, it is not an issue where we are active. It is one that we have a natural interest in, but we have not seen a ready way to resolve it.

**Mr HUMPHREYS**—Just on the Barings issue, when you say you do not know exactly what happened and you have not been able to trace all the information, will you ever be able to? Will the world ever know what really happened? In that situation, the culprit said he did not want to go back to Singapore because they might do away with him because he knew too much about the internal activities. So is it a case where we will never know what really happened or where the money has gone?

**Mr Hall**—We cannot tell. My guess is that over time it will come out, and that there will be enough people who will know the story. There will be enough evidence still left somewhere. There have been some reports that some of the documents have been destroyed, but there are usually ways of making those up from the other side.

**Mr HUMPHREYS**—What I am trying to get at is: if you do not know, how are you going to deal with the situation? How can we ever stop it from happening?

**Mr Hall**—I think in the Barings case one can make a number of assumptions as to what probably happened. There are two or three alternatives: he may have acted on his own, acted partly on his own, or acted with the connivance of, or with the knowledge of,

a number of other parties, and I presume all that will come out. But whether it does or not, each of those scenarios is one that we will take into account in our deliberations.

**Mr HUMPHREYS**—The old saying is 'Where is the money coming from?' but in this case we are asking where the money has gone to. Will they ever know who got it all?

**Mr Hall**—I think in that case that will be quite easily shown. It will be just the counter parties to all the transactions that Barings was involved in, and that will be very much on the record of the exchange in Singapore.

**Mr Lonergan**—If you see any comfort—and it may be little comfort—if we go back to the AWA situation here in the 1980s, it took many years before that came to court and all the facts were publicly known. In the meantime, many banks very quickly radically altered their existing practices: for example, the practice of entering into what is called an 'historic rate role' which was relatively widespread, ceased relatively quickly after the first public glimpse of the AWA loss came out into the open. So the market reacts fairly quickly to these things even if they are not absolutely fully informed, which I think is in support of the point that Leigh made. Similarly, bodies such as CASAC, which have consultative groups with lots of contacts, will have a reasonable feel for what went on.

**CHAIR**—I just have a couple of final questions. The first one is about coordination. From the committee's point of view, so far we have had evidence from you, from the ASX, from the SFE and from the ASC. The other interested regulators, if you like, are the IAC and the RBA. There are any number of professional groups which have got an interest: the AIMA and the ASCT, the treasurers yesterday—

**Mr Lonergan**—Accounting Standards Board.

**CHAIR**—There is a whole range. Are you satisfied, or do you have a view about whether the response to Barings, in addition to everyone going through their own cleaner, so to speak, is a coordinated approach or response?

**Mr Hall**—I think one of the illustrations of how much support there is that something can be done to improve the situation is when you look at the composition of our own consultative group on this issue where just about every organisation that there could be is represented. They might not all be there as representatives of an organisation

or might not be shown in that way but the number of cross-memberships and the professionals who are the professionals working on behalf of various other organisations are there, so that we see that we have the full cooperation, if you like, of all of the interested groups, whether they be regulators or participants.

**Senator GIBSON**—Because Leigh has outlined a timetable of this very issue that you are looking at, running through to the end of this year, I am just wondering whether this committee should consider meeting with you on a periodic basis between now and the end of the year to make sure that we are well informed about progress and where you are getting to. That would demonstrate to the parliament, as queries will certainly arise from time to time, that we are doing something as a committee to keep on top of what is actually happening in this area.

**Mr Hall**—I am sure Leigh and his members would be most pleased to keep you up to date with what is happening.

**Mr HUMPHREYS**—Just going on from what Mr Sinclair was saying in relation to Skase and Bond, is it still possible for company directors such as the Skases and Bonds to take lots of money and bury it overseas, hide it, stash their millions of dollars? Is it still possible today that that could happen without the Australian public knowing that they were doing that? For people such as Skase who loaded all his furniture and his Rolls Royces into containers and took them to Spain when everyone knew they were not coming back, is that still possible?

**Mr Hall**—It is never possible to stop fraud; it is not possible to stop human dishonesty. So you can put in place as many safeguards as you can but it is still possible for those things to happen. If the right corporate governance is put in place, it would be that much more difficult. In those instances where the entrepreneur, if you like, is virtually in sole charge of the organisation without there being any real supervision by the remainder of the board as to what the activities of the company are, then it is much easier for that to happen. It is for this reason that the professional investors, in particular, but also others, such as the Australian Shareholders Association, are taking a lot more interest in the way companies govern themselves to make sure that there are those proper checks

and balances. They cannot guarantee it will not happen but they will make it more difficult and there is more chance that somebody will say, 'What's going on?' If they are not satisfied with the answer, they will then blow the whistle.

**Mr HUMPHREYS**—As Mr Lonergan was saying, they cannot do this unless they have got assistance from banks or whoever. Is that what you were alluding to before? They had to have assistance to be able to do that, and they had to transfer their money overseas through a bank—they just cannot do it themselves. As you say, they had to be aided and abetted by—

**Mr Hall**—It will depend on the circumstance. There are a lot of ways of legitimately transferring funds. I think what Wayne was referring to was the type of fraud where a dealer within a company has a counterpart who is a dealer with another company or institution; they agree to enter into a deal which will be disadvantageous for dealer A but profitable for the other one. Then the other one has some sort of under the counter arrangement with dealer A to give dealer A part of the proceeds. In effect, dealer A is stealing from his or her employer.

**Mr Lonergan**—The other issue in support of Leigh's point about governance is disclosure and the need to disclose market to market information as opposed to historic information, because one way of camouflaging losses is to adhere to the historic cost accounting system and not own up to the fact that the market has moved against you. Therefore, it is very important that market to market information about derivatives is disclosed in the public arena. That way it flushes out the loss or the misbehaviour as quickly as is practical.

**Mr Hall**—And the same goes for any other asset class which is volatile in its pricing.

**CHAIR**—In your tabled statement there is a good paragraph to that effect. You are talking about the Australian Society of Corporate Treasurers and the ASC's proposal, which we heard of yesterday. You say, on page 9 of the written submission:

The Advisory Committee anticipates possible opposition to a statutory enhanced disclosure regime. Participants may be concerned that the true level of their exposure is misrepresented or confused with notional principal amounts. There is also the possibility of market over reaction. As one commentator has put it, while market

disclosure 'may be a safeguard against ill-informed panics, when an institution really is faced with a potential solvency problem the market's verdict will be immediate, savage and final'.

**Mr Hall**—One would hope, of course, that an organisation would have taken the requisite remedial action before it is apparent that they have that much trouble. But one thing is for sure, if they do have that much trouble, it is only fair that the rest of the market knows so that the rest of the market can protect itself. Otherwise you run the risk of the contagion problem, the domino effect.

**CHAIR**—It is just further, uncontrovertible argument in my view about the need for continuous disclosure and constant transparency. If you have that, then you at least have a chance that people who are taking risks are taking risks which are open and transparent, and they live or die on the basis of their judgments. The unfairness or the fraud arises where the risk is an opaque risk because things are not disclosed to you. And that applies in derivatives, so much of corporations and securities activity.

**Mr Hall**—Yes, that is certainly true.

**Mr SINCLAIR**—This is more a matter of information than necessarily something of some substance: I have never quite understood junk bonds. If junk bonds were to be developed in the Australian market, where and under what category and section would they be regulated?

**Mr Hall**—We have had junk bonds. All of the debentures issued by various companies that have failed—

**Mr SINCLAIR**—They are junk.

**Mr Hall**—They have certainly been junk bonds. The term 'junk bonds' has just been used to describe the fixed interest securities issued by corporations who do not have a high credit rating. They are, on the fact of it, fixed interest securities with a higher risk than the sort of top grade corporate or sovereign risk. Accordingly, they pay a higher rate of interest. For investors who can assess risk, they can be very good investments, because if you know that the corporation issuing them is really sound but, just because it is small or new or whatever, it does not yet have a high credit rating, you can get a higher rate of interest.

In Australia nowadays we do not have so many of them because there really is not

much in the way of a corporate borrowing market here. There are very few corporates going to the public for funds nowadays. Most corporates finance themselves through the banking system and it is the banks who will make that assessment. If they say the borrower is of junk quality, of course, they charge them that requisite rate of interest.

**Mr Lonergan**—Theoretically, the prospectus provisions of the Corporations Law should flush all that out.

**Mr SINCLAIR**—So when you are issuing new debentures you would have to issue a prospectus—something like that, yes.

**Mr Lonergan**—Again, theoretically, the continuous disclosure requirements mean that once you have issued them, if your position deteriorates, that should be flushed out as well. I guess the only difficulty with that at the end of the day is that the unsophisticated investor, attracted by the nominally higher rate of return, may not fully understand that information. But that applies across a whole cross-section of investment situations.

**Mr Hall**—And just on the subject of junk bonds in the states, there really has not been anything wrong with most of the junk bonds. It is unfortunate that they are given such an unfortunate name.

**Mr SINCLAIR**—They have certainly attracted a certain notoriety as a result. In the rural sector one of the real problems—and I do not think it has applied so much in the corporate sector—has been where people have entered into overseas loans and not taken cover. I mean, AWA had problems with foreign exchange cover. There is an obligation to disclose if you are borrowing money generally, because that would come out in the balance sheet, but how does this exchange risk appear? It is only balance sheet disclosure that would tell you that you had moved into an area where, while the interest rate was reasonable, the exchange rate cover was such that it left you exposed; there is no obligation to disclose whether or not you have taken out foreign exchange cover. In AWA the risk was not disclosed till well after the foreign exchange moved against them.

**Mr Lonergan**—AWA was slightly different. The dealer there was speculating in US dollars and Japanese yen and the market went against him, in particular in US dollars. The rural loans you are talking about were issued by banks, and what you say is quite

correct: the banks went out and told the rural people they could have money at five or six per cent in Swiss francs, for example, when the prevailing Australian rate might have been 15 or 16 per cent. What the bank managers did not understand, even if their head offices did of course, was that there was a corresponding currency risk that eliminated that gap because otherwise the capital markets would just arbitrage that away.

There have then been a whole series of court cases dealing with that issue, most of which have been quietly settled, and many of those settlements have been on the basis—not all—that the farmers ultimately paid the bank what they would have paid had they borrowed in Australian dollars in the first place, but if there was some other incremental loss, even beyond the apparent arbitrage difference, in many cases the banks have copped that sweet—or not so sweet as the case may be.

I think that in today's environment the banks are very aware of their obligations to their clients, partly because of all the litigation, and I would be most surprised to see a bank pursuing that practice today without putting their clients very much on notice as to what the risks were. I would like to think that problem was behind us. There may be an individual manager somewhere or a few of them who do not really understand, but the banks are pretty conscious of it today.

**CHAIR**—Thank you very much for your attendance here today. We will no doubt take up the deputy chairman's suggestion that we speak to you on these matters as time proceeds. We will do that by way of public hearing or by way of private briefing, but while your work continues this will no doubt be of some interest to the committee. Thank you very much for attending today, for your opening statement and for your assistance to the committee in its deliberations.

**Committee adjourned at 10.52 a.m.**