FUTURES INDUSTRY BILL 1986

Date introduced: 16 April 1986
House: House of Representatives
Presented by: Hon. Lionel Bowen, M.P., Attorney-General

DIGEST OF BILL

Purpose

To provide the framework for the national regulation of the futures industry through the regulation of the futures industry in the Australian Capital Territory (ACT).

Background

Following negotiations between the Commonwealth and State Governments during the 1970s, a formal agreement was signed for a 'Commonwealth-State Scheme for Co-operative Companies and Securities Regulation' in December 1978. Under the scheme, a 'Ministerial Council for Companies and Securities' was created comprising the six State and the Commonwealth Ministers responsible for companies and securities. Unanimous approval of the Ministerial Council is required before any law can be adopted. Furthermore, it was agreed that once the Council had approved company or security legislation, it would be first passed by the Commonwealth and then adopted by the States.[1] This Bill will apply to the ACT only and will be followed by corresponding State and Northern Territory legislation.

Futures, which form the basic trading unit of the futures markets, may be defined as agreements to buy or sell a commodity at a certain price on a specified, future date. The major reason for their existence is a difference, real or expected, between the current (spot) price for a commodity and the future price. The difference between the spot and future prices need not actually exist at the time a futures agreement is entered for there to be sufficient incentive to enter into the agreement. An expectation that
there will be a difference between the spot and future prices when the agreement matures will provide sufficient incentive. For example, if (i) an importer has a commitment to pay a certain amount of US$ at a specified time in the future and (ii) the importer expects that the $A will depreciate against the US$ and (iii) the importer is able to arrange a futures contract that will guarantee an exchange rate at the time the payment is due that is more favourable than that expected by the importer, then the importer will have an incentive to enter that futures contract although the spot and futures prices may not differ at the time the contract is entered into. Futures trading is largely dependent on differing expectations. Actual delivery of a commodity rarely occurs under a futures agreement, the difference between the futures price and the spot price at maturity generally being paid out.

Theories on future market operations generally give three reasons why people are involved in the market, namely arbitrage, hedging and speculation. Arbitrage will occur when the spot and future prices differ sufficiently to cover extra costs. For example, if the futures price exceeds the spot price by more than the cost of carrying the commodity until the maturity date of the futures contract, a riskless profit can be made by buying spot, selling futures and making delivery under the futures contract.

Hedging describes the activities taken by someone who faces the risk of uncertain future prices to transfer that risk to another. For example, a grain grower may sell forward to off-set the risk of a price fall at harvest time while a miller may buy grain forward to off-set the risk that the spot price when he requires the grain will be higher than the forward price. This form of trading is dependent on differing price expectations. Speculation is also dependent on differing price expectations but, unlike hedging, the transaction is not undertaken to reduce risk. Indeed, the speculator accepts other risks on the basis that his expectations of future price movements are correct. As success or failure depends on personal expectations, speculation on the futures market is often likened to gambling.

The first futures market to open in Australia was the Sydney Greasy Wool Exchange which commenced operations in May 1960. The name was soon changed to the Sydney Futures Exchange (SFE) and the range of goods dealt in was expanded to include other agricultural products, such as cattle and boneless-beef, and gold. However, the largest
expansion in SFE's operations occurred in 1979 when trading on financial futures was introduced. The range of markets operated by the SFE now includes wool, cattle, gold, silver, 90-day bank bills, US dollars, Share Price Index futures and exchange-traded options. Financial futures dominate SFE's activities and wool futures currently amount to only 1% to 1.5% of SFE's business.

It is difficult to estimate the value of the business conducted by SFE, largely because trading is done on a deposit basis with only 5% to 10% of the value of the futures agreement being paid in advance and actual delivery rarely occurring. However, some idea of the growth of SFE's business can be gauged from the number of contracts negotiated. It took 14 years to trade the first million contracts. A cumulative total of two million was reached in May 1980, three million in July 1981 and four million in July 1984. Over one million contracts were traded in 1985 to bring the cumulative total to over five million. Currently, average turnover is approximately 12 000 contracts daily.

In October 1985 Australia's second futures market, the Australian Financial Futures Market (AFFM), opened in Melbourne. Trading is restricted to Australian Futures Contracts (AFC's) which are based on the value of a particular company's shares. Trading is currently restricted to eight 'blue-chip' companies listed on the Melbourne Stock Exchange.

The need for national regulation of futures markets was raised in the Campbell Report, which was delivered in September 1981, and recommended regulations comparable to those applying to stock exchanges.[1] Exposure drafts of proposed futures legislation were released for public comment in October 1984 and November 1985. In its submission on the 1985 draft Bill, the SFE stated:

The Exchange strongly supports the implementation of the Bill at an early date and would not wish enactment of the Bill to be delayed. The Exchange believes that it is important that the industry is, and is seen to be, appropriately regulated and the Exchange is ready to perform its own role in the co-regulatory process.[2]
Outline

The Bill defines futures contracts, requires futures brokers to be licensed, provides for investigations, the approval and regulation of future exchanges and will establish a fidelity fund.

Main Provisions

For a detailed analysis of the clauses of the Bill refer to the Explanatory Memorandum.

Futures contract is defined in clause 4 to include an eligible commodity agreement (also defined in clause 4), a futures option or an agreement included in a prescribed class. This is a very wide definition and aims to counter any artificial arrangements entered into to escape this Bill's jurisdiction.

The situations in which a person will be taken to be dealing in futures contracts are contained in clause 7. A person will be dealing in futures contracts if they acquire or dispose of futures contracts, offer to acquire or dispose of such a contract or induce or attempt to induce another person to acquire or dispose of a futures contract.

Part II of the Bill (clauses 12 to 44) deals with administration. The major provisions in this Part include:

- the Bill will be administered by the National Companies and Securities Commission (NCSC), whose power to required books to be produced is listed in clause 13 (it will be an offence to fail to produce the books requested (clause 15));

- the NCSC will be able to investigate matters if it has reason to believe an offence has been committed (clause 19);

- the Minister and the Ministerial Council will have power to request the NCSC to investigate certain matters (clause 22);

- the procedure for conducting investigations is contained in Division 2 of Part II (clauses 23 to 42); and
a Futures Consultative Committee may be established by the Ministerial Council to advise the Ministerial Council and the NCSC on such matters relating to the futures industry as are referred to it (clause 43).

Part III of the Bill (clauses 45-59) deals with future exchanges, clearing houses and futures associations. It will be an offence to operate a futures market that is neither part of a futures exchange or an exempt futures exchange (clause 45). The Ministerial Council will have power to approve exempt bodies (clause 45) and future exchanges if they satisfy the criteria listed (clause 46). It will also be an offence to operate a clearing house unless it is approved (clause 47). The Ministerial Council may approve a clearing house if it satisfies the criteria listed (clause 48). As well, future associations must be approved (clause 50). The Ministerial Council will also have power to cancel or suspend approval (clause 51). The NCSC will be given power to appeal against certain decisions of future exchanges and associations (clause 53). The NCSC will also have power, including the power to close, suspend trading, or direct to ensure the orderly functioning of future exchanges (clause 56).

Part IV (clauses 60 to 80) deals with the licensing of brokers, brokers' representatives and advisers. It will be an offence for a broker, a brokers' representative or adviser to deal in futures without a licence (clauses 61, 62 and 63). Clause 66 lists the criteria which must be satisfied before the NCSC grants a brokers' licence, while clause 67 deals with representatives' licences. Licences may be subject to restraints and conditions (clause 69). Clauses 77 and 78 deal with the revocation or suspension of licences while clause 80 states that a licence is not to be suspended or revoked and conditions are not to be imposed or varied unless the licence holder has been given an opportunity to appear at a hearing before the NCSC.

The conduct of futures business is dealt with in Part V (clauses 81-87). A licence holder is not to hold out that their ability or qualifications have been approved by the NCSC (clause 81) and 'undesirable advertising' can be prohibited (clause 82). Brokers will be required to issue contract notes to clients (clause 83) and to furnish monthly statements to clients (clause 84). Brokers' personal dealings are to be listed separately (clause 85) and clients' and the brokers' money and property must be kept separate (clause 86).
Part VI (clauses 88 to 104) deals with accounts and audits. Clause 90 deals with the accounts to be kept by brokers, while clause 92 deals with the appointment of auditors. Auditors will be required to report 'prescribed matters' (i.e. a breach of this Bill or any matter that has or will adversely affect the brokers' ability to meet his obligations) to the NCSC (clause 97). A Court will be able to restrain dealings in a brokers' accounts in certain situations (e.g. where there is a deficiency in the client's accounts) (clause 101).

Fidelity funds are to be established by Part VII (clauses 105 to 127). Such funds are to be established by relevant organisations, i.e. future exchanges or associations (clause 106). The fund will consist of money paid in by relevant organisations and interest earned (clause 107). Clauses 112 and 113 deal with annual contributions to the fund and the levy that may be imposed on members of relevant organisations. Fidelity funds are to be used to compensate people who suffer a pecuniary loss due to the defalcation or fraudulent misuse of money or property by a contributing member of a relevant organisation (clause 116). The Board of a relevant organisation will be able to settle compensation claims (clause 120).

Part VIII (clauses 128 to 139) creates a number of offences. These include:

- a person is not to deal in futures concerning a corporation if that person has been connected with the company in the preceding six months and has inside information (clause 129);

- a person is not to create or maintain an artificial price level (clause 130);

- a person is not to induce fraudulently others to deal in futures (clause 133); and

- a person guilty of an offence may be liable to pay compensation (clause 137).

Clauses 140 to 160 (Part IX) deals with miscellaneous matters. People are not to conceal or falsify books (clauses 144 and 145). Clause 150 provides a $50 per day additional penalty for continuing offences and the courts will have power to prohibit the execution of futures
contracts in certain circumstances (clause 155). Clause 160 will allow the Governor-General to make regulations under the Bill.

For further information, if required, contact the Economics and Commerce Group.

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5 May 1986

References

2. Explanatory Memorandum for this Bill, p.16.