Sydney Futures Exchange

Submission to

Financial System Inquiry

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Executive Summary

- Derivative markets, and financial markets generally, make a significant contribution in our domestic economy and in linking us into the wider global economy.

- Relatively few changes are required to the current allocation of responsibilities between regulatory agencies in order to ensure that financial markets achieve their optimal contribution to the Australian economy.

- To reduce regulatory gaps and overlaps, the statutory responsibilities of government regulatory agencies should be expressed, where possible, in terms of economy-wide objectives or outcomes to be promoted (such as stability of the financial system; competition; fairness, efficiency and orderliness of markets etc) rather than by reference to classifications of institutions, products or users (such as banks, securities, investors, consumers).

- The ASC's core responsibilities should continue to involve promotion of the fairness, efficiency and orderliness of financial markets (market efficiency regulation). This element should not be neglected in the course of devising proposals for better harmonisation of the ASC's consumer protection responsibilities with those of other agencies.

- The Reserve Bank's responsibility for monitoring potential threats to the stability of the financial system (systemic risk) should explicitly extend to monitoring the management of risks in all clearing and settlement systems. Factors supporting this include:

    - the direction in which markets are moving, with provision of facilities for matching and settlement of transactions no longer being provided exclusively by the same entities which provide facilities for trading;

    - convergence of skills needed for supervising financial institutions and supervising management of risks in multilateral netting facilities, namely skills in assessing the processes by which risks are managed and managerial capabilities.

Part 1: Structure of SFE Contribution to Inquiry

The Sydney Futures Exchange is the largest open-outcry futures exchange in the Asia-Pacific region. Having successfully operated both open-outcry and screen based risk management markets for many years, the Exchange has developed a significant position in the financial markets.

In making its contribution to the inquiry, the Sydney Futures Exchange has focussed on three broad aspects of the terms of reference, from the perspective of financial markets:

- a stocktake on the current environment;
- what the future may entail; and
- regulatory changes, if any, needed to get there in good shape.

We have addressed these three aspects in the following ways:

- stocktake - by commissioning, jointly with other leading financial market organisations, the collection of comprehensive data and independent analyses on the function, structure and contribution to the economy of Australia's financial markets;[1]
- the future - by providing an insight into the drivers of change which we believe will influence the way organisations such as ours can continue to make a vital contribution to the economy. [2]
- regulation - by articulating a set of principles which we believe would assist the inquiry in using its own stocktake of the present and its own vision of the future to craft a regulatory structure which is consistent with efficiency, stability of the financial system, and fairness. [3]

The role of financial markets in efficiently deploying resources and the importance of a viable financial sector cannot be properly appreciated without some idea of the scale of these activities and their interdependencies. The research paper "Australia's Financial Markets:

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[1] Securities Industry Research Centre of Asia Pacific, "Australia's Financial Markets: Function, Structure and Contribution to the Economy", September 1996 prepared for Sydney Futures Exchange and Australian Financial Markets Association - to be submitted to Financial System Inquiry in conjunction with this SFE submission and separate AFMA submission; Allen Consulting Group Pty Ltd, "Australia's Capital Markets", June 1996 prepared for The Sydney Futures Exchange, the Australian Stock Exchange, and the Australian Investment Managers' Association.

[2] See Part 2 of this submission and Attachment A, being article by Weeden J. "SFE in the Year 2020 - Liquidity, Risk and Global Relevance", to be printed in Journal of Applied Finance and Investment, September/October 1996.

[3] See Parts 3 and 4 of this submission.

Function, Structure and Contribution" produced by the Securities Industry Research Centre of Asia-Pacific (SIRCA) provides such a stocktake.

With this grounding, it is then possible to undertake an analysis of drivers of change which is more than idle speculation or "crystal-ball gazing". Case studies on how significant components of the financial markets are addressing the opportunities and challenges presented by technological change and globalisation may help the inquiry identify commonalities with other sectors as to the most significant drivers of change. To this end, we have included (Attachment A) a think-piece recently prepared from the Exchange's perspective on liquidity, risk and global relevance. In the next part of this submission, we step back from guessing the shape of the SFE's business in 25 years time and talk about the next 12 months. In particular, we comment on competition in physical or cash markets, particularly the equities market.

Just as the structure and function of the various financial market components need to be understood to appreciate the contribution which they make to the economy, so too does the structure and function of *existing* regulatory arrangements need to be understood before improvements can be made.

The Sydney Futures Exchange is in a very good position to comment on optimal regulatory structures because of the dual positions it occupies as market facilitator and market regulator. It is a self-regulatory organisation, supervised by a single government agency - the Australian Securities Commission as to how well the Exchange supervises the conduct of its members. At the same time, those member organisations are subject to supervision and regulation by a range of agencies.

The appropriateness of this regulatory structure is currently the subject of a review being conducted for the Treasurer by the Companies and Securities Advisory Committee (CASAC). In the course of responding to the Committee's proposals [4] for amendment of the Corporations Law, the Exchange has identified six issues which it considers must be addressed before one can determine the boundaries of appropriate functional regulation. An extract from the Exchange's response to the CASAC proposals, containing a discussion of these issues, is set out at Attachment B.[5]

The issues which arise in meshing functional regulation regimes which impact on derivatives trading in all manner of commodities and financial instruments are not dissimilar to the issues faced when reviewing boundaries between regulatory frameworks generally. In Part 3 of this submission, we identify some principles of general application.

One conclusion which we believe emerges from testing those principles against current arrangements is that relatively few changes are required to the current allocation of responsibilities between regulatory agencies (particularly between the Reserve Bank and the Australian Securities Commission) in order to ensure that financial markets achieve their optimal contribution to the Australian economy. We acknowledge that much more significant

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[4] Companies and Securities Advisory Committee, "Regulation of On-exchange Derivatives Markets, Draft Report", June 1996.

[5] Copies are available from the Exchange of the complete text of Sydney Futures Exchange, "Response to draft Report of the CASAC Regulation and On-Exchange Derivatives Markets", September 1996.

rationalisation of agency responsibilities may be needed to introduce a more functional approach to regulation of activities not involving conduct of a market.

The fact that we are relatively sanguine about the current interaction between market activities and regulatory/supervisory agencies does not mean that we see no scope for change. In Part 4 we outline proposals for change. In particular we suggest that oversight of clearing and settlement systems with a view to ensuring stability of the financial system should be regarded as a discrete subject of functional regulation. In other words, even though other agencies may have an interest in the arrangements by which transactions conducted on one or two organised markets are settled, the systemic risk supervisor (Reserve Bank) should have an over-arching responsibility to oversight all clearing and settlement arrangements from a prudential supervision perspective.

Furthermore, even though we are relatively sanguine about the broad division of functions between these regulatory agencies whose activities have the most direct relevance to financial market activities, we see a significant role for Government in addressing non-regulatory issues. We support the establishment, for example of a Financial Markets Council - as outlined in the Capital Markets Report [6] - to help build the mindset of a co-operative partnership between Government and the financial markets for competitive economic development.

[6] The Allen Consulting Group Pty Ltd, “Australia’s Capital Markets”, June 1996, Chapter 14.

Part 2: The Future of Markets

Financial markets are unlikely to change so much that they lose their primary function of being a medium for the efficient development of resources. But many other aspects are likely to change, particularly how they interact with other sectors of the economy.

In this part, we focus on one development - the “unbundling” of services - which is evident in a range of areas. Just as the provision of loans is no longer the exclusive preserve of deposit-takers, nor is efficient price discovery likely to remain the exclusive preserve of exchange markets as we know them today. Furthermore, entities which traditionally operated trading facilities for a single market sector are expanding into quite distinct areas.

The Sydney Futures Exchange, for example, is not only expanding its range of risk management facilities of the traditional type (futures and options) by providing them for new industries (ie over new underlying products) but is also expanding the types of trading facilities which it provides. To date, those new facilities have still been in the risk management area, such as the provision of facilities for matching trades effected by electricity swaps participants. (With this development the boundary between exchange traded and otc derivatives is no longer so clear.)

But the Exchange is also likely to move into provision of trading facilities for some cash market instruments (as well as retaining its core risk management products). Just as providers of trading facilities for physical (or cash market) instruments such as shares have expanded into provision of facilities for trading of derivatives over shares, in competition with existing derivative markets, so too will the reverse occur: providers of facilities for trading of derivatives over shares will establish facilities for trading shares in competition with existing markets. Both developments should be encouraged (so long as regulatory arrangements appropriate to every separate type of activity are retained).

In days gone by, this type of development might have been greeted with calls from established markets for Governments to protect them from competition. The concern might well have been expressed as a concern on behalf of the public that users of their markets would lose out from a loss of liquidity in the established markets.

Nowadays one would hope that Governments would be much less included than in the past to take such claims on face value, given the wealth of studies which have demonstrated the ways in \which different types of new market can actually add to liquidity by complementing existing structures.

Other leading financial centres have already understood these benefits as reflected in governments authorising new stock exchanges to compete with existing exchanges (such as Tradepoint in the UK, and the variety of trading structures authorised in the US ranging through NYSE and NASDAQ structures to the call markets operated by, say, the Arizona Stock Exchange).

Within the next twelve months, provided Governments demonstrate the requisite commitment to encouraging competition, we would expect to see facilities in place in Australia, for example, which enable fund managers to choose between the existing broker facilitated market in shares and facilities for dealing direct with other fund managers.

In the same way that provision of trading facilities is likely to undergo significant development in the near future, so too is development of the range of settlement and clearing facilities. Furthermore, existing skills employed in clearing particular of trades are likely to be deployed into clearing quite differently structured trades. For example, instead of a clearing house simply clearing trades effected on an associated futures market, the same skill sets could be deployed to provide facilities for managing the risks associated with otc derivatives transactions.

This can be seen in the development efforts of a number of organisations in Europe and North America towards creation of swaps depositories. Similar initiatives covering dealings in A$ denominated instruments and the currencies of the Asia-Pacific region can be expected.

Another significant development in recent years relating to management of risk concerns the netting of financial market exposures, particularly those arising from derivatives transactions. Much more important even than regulatory structures providing for oversight by a government agency of concentrations of risk within the financial system (discussed in subsequent parts of this submission) is the market infrastructure for reducing risks. These range from the existence of novation netting arrangements within exchange market clearing houses through to arrangements for bi-lateral close-out netting of otc derivative transactions. There are also initiatives like real time gross settlement.

All of these add up to a collection of clearing and settlement arrangements which warrant a discrete supervisory focus independent of the particular underlying commodities or financial instruments which are being traded. In Part Four of this submission we highlight this as the one area where we see room for some readjustment of existing responsibilities for regulatory agencies in the financial markets area.

Conferral of an explicit responsibility on the prudential supervisor (of those organisations whose failure could have systemic consequences) to oversight all manner of clearing and settlement arrangements, independently of regulatory arrangements applying to specific trading markets, would be consistent with the role of prudential supervision. The Reserve Bank (and not just the ASC) has an interest in the financial strength of the clearing house of futures and options exchanges, especially if the members of those clearing houses include banks supervised by the RBA and those banks have substantial mutual obligations arising out of their clearing house membership.

As the unbundling of trading facilities from settlement services gathers pace, the wisdom of having different regulatory regimes for physical and derivatives markets (as at present) will also become more apparent. At the moment, the existence of numerous similarities in regulatory instruments applied to supervision of physical and derivatives markets respectively has led some to gloss over the significant differences which also exist and promote greater harmonisation of the two regimes. The in-depth inquiry being conducted by the Companies

and Securities Advisory Committee has exploded the myth that there is significant scope for further harmonisation, or that harmonisation (eg. By having a single regulatory regime for all financial instruments) is even desirable.

(For a more complete analysis of the problems which would arise if regulation of trading facilities for derivatives were to be brought more into line with regulation of physical markets in one particular physical market-equities - see the Exchange's various submissions to the review being conducted by the Companies and Securities Advisory Committee; an extract from the latest is at Attachment B.)

In the next part of this submission, we discuss some principles with which the existing regulation of financial market activity is generally consistent, which may have wider application to non-market issues being addressed by the inquiry.

Part 3: Functional Regulation: Principles of General Application

Debates about different approaches to regulation are sometimes summarised as involving choices between "functional" and "institutional" approaches. Identifiable differences between these two approaches are clear enough to make this a useful starting point. But that is all.

The harder next step is to determine how many discrete "functions" exist around which regulatory structures need to be built and how the inevitable crossovers between different regimes can best be managed. One simply has to consider the single activity of "investing savings" to recognise (a) the importance of correctly defining the activity, and (b) the inevitability of different aspects of the same activity being governed by more than one regulatory regime.

Without even taking into account regulatory regimes established under other laws, the activity of "investing savings" is potentially impacted (legitimately, in our view) by five separate sets of provisions under the Corporations Law alone. Those provisions focus respectively on:

(a) the investor/saver as a person owed *fiduciary* duties, with the conduct of the person owing fiduciary duties being regulated or supervised (eg. collective investments provisions which focus on relationships such as fund manager/trustee/ beneficiary more than on products);

(b) the investor/saver as a sub-set of *customers* (eg. provisions regulating broker/client relationships, takeovers and financial market activities where trades on behalf of various customers (not merely "savers") are effected;

(c) the investor/saver as a sub-set of all *corporations* (eg. directors duties; obligations to prepare financial statements; company formation, governance and winding up);

(d) the investor/saver as *investor/saver* (eg. the securities market provisions mandating prospectus disclosure, transfer of marketable securities etc);

(e) the investor/saver as a sub-set of Australian *businesses* (eg. derivatives market provisions which focus on transferring price risks - not limited to risks faced by investors/savers - in a manner which is fair and minimises systemic risk).

Moreover, different ways of describing the same activity could dramatically alter the scope of a regulatory agency's charter. This can be demonstrated by posing a rhetorical question as to whether the Sydney Futures Exchange group is supervised by the Australian Securities Commission under the current law because it:

- provides a market? (futures and options?)

- provides a particular type of market?

- creates liquidity?
- creates liquidity in a particular way (novation clearing?)
- facilitates transfer of price risks?
- facilitates price discovery?
- provides facilities for the trading of instruments accessible to retail participants?
- provides settlement facilities?
- provides clearing facilities?
- provides clearing facilities for a particular type of market?
- is an integral part of the financial markets?
- contributes to the efficiency with which resources are allocated?

It is too easy to simply say "all of the above". Subtle but significant differences between different types of markets, for example, explain why derivatives markets (irrespective of the underlying) are appropriately regulated differently from the underlying market when it comes to financial market efficiency regulation (ASC-type regulation). (Regulation of equity derivatives currently constitutes an anomaly which the proposals in the recent draft report by the Companies and Securities Advisory Committee, if implemented, would overcome.) Equally significant differences in risk between *clearing* of physical market transactions (involving transfer of the physical commodity) and clearing of derivative transactions (involving guarantees of performance) are less well understood. Not surprisingly, therefore, supervisory arrangements tend to bracket dissimilar clearing and settlement services together and apply the same instruments of supervision. This particular issue is discussed more fully below (Part 4: Proposals for Change) and in Attachment B.

For present purposes, it is sufficient to note that we regard the basic structure of futures market regulation as being consistent with principles which might usefully be adopted in other areas as well (although pending implementation of CASAC proposals, regulation of equity option trading retains some anomalous features).

In the course of that review, CASAC has had to grapple with many of the same issues which form part of the Financial System Inquiry's charter, eg:

- how to delineate prudential supervision, consumer protection regulation and market integrity regulation
- so as to maximise the objectives of those three strands of regulation
- whilst paying due regard to issues such as innovation and competitive neutrality.

The following principles might usefully serve as a basis for assessing the extent to which current allocation of responsibilities between regulatory agencies (not limited to financial markets activities) is appropriate. In order to demonstrate the application of these principles to a specific "activity", the principles are then applied to the activity of "futures and options trading on organised markets".

We believe the following principles could usefully be applied not merely to this specific activity but as a template for addressing a host of issues concerned with regulatory gaps and overlaps:

- *Supervision by reference to objectives or outcomes.* To reduce regulatory gaps and overlaps, the statutory responsibilities of government regulatory agencies should be expressed, where possible, in terms of economy-wide objectives or outcomes to be promoted (such as stability of the financial system; competition; fairness, efficiency and orderliness of markets etc) rather than by reference to classifications of institutions, products or users - (such as banks, securities, investors, consumers).

- *Board responsibility for corporate governance.* The regulatory framework should recognise the primary responsibility of the board of an incorporated participant in the financial system, rather than any regulatory agency, for balancing the need for managerial risk taking with the need to ensure that management's direction is aligned with the interests of shareholders and creditors (corporate governance).

- *Prudential supervision.* A government agency having the power to require a board to do what the agency considers prudent instead of what the board considers an appropriate risk should only be accorded such powers in respect of a relatively small number of financial service providers, namely those whose inability to meet their commitments as they fall due may constitute a potential threat to the stability of the financial system eg. because of their involvement in the payment system.

  (The question as to whether there should be more than one prudential supervisor is not an issue of primary concern to the Exchange. Nor is the question as to whether there should be more than one consumer protection regulator an issue of primary concern. The Exchange's focus is on the potential for overlap between prudential supervision and financial market efficiency regulation, as reflected in subsequent recommendations.)

- *Consumer protection licensing* Any other authorisation regimes administered by government agencies (ie other than the prudential supervision regime(s) directed at ensuring stability of the financial system) should not merely be triggered because an entity conducts a business involving a particular product or type of activity. These other authorisation regimes should only be triggered when such activities involve:

  (a) retail participation,

(b) some fiduciary relationship which warrants an authorisation regime as a form of "fit and proper person" certification, or

(c) a demonstrated link between licensing requirements and achievement of financial market efficiency.

- *Financial market efficiency/conduct of business regulation.* Any regulation affecting the involvement of the vast majority of participants in financial market activities should be directed at enhancing the benefits to the broader economy which such activities have the potential to produce, such as:

  (a) enhancing the allocative efficiency of markets in shares and bonds and other investments ie channelling savings to productive investments, or

  (b) enhancing the price discovery function of tertiary markets in futures and options because this helps ensure fair prices in markets in the underlying commodities.

- *Retention of ASC.* The ASC should continue to exist separately from any prudential supervisor(s). Its diverse responsibilities provide a link between:

  (a) regulation of market activity in the interests of fairness and orderliness;

  (b) corporate governance; and

  (c) the infrastructure necessary to support the corporate form.

- *Desirability of multiple activity-based regulatory regimes.* Activity-based regulatory regimes, such as several of those administered by the ASC (eg. regimes based on the "activities" of managing collective investments, entering futures contracts, transferring rights against companies etc), necessarily and desirably involve each individual and business enterprise being impacted by several different regimes in respect of a single transaction.

- *Regulation of organised markets in futures and options.* Activity-based distinctions appropriate for one purpose - such as a distinction between futures and physical commodities (including shares and bonds) for purposes of supervising the different risks undertaken by different types of clearing houses - may be less relevant for other purposes such as licensing of intermediaries.

The following table demonstrates some of the general principles of broad application which the inquiry might usefully adopt and what this would mean for a specific area of financial market activity, namely futures and options trading on organised markets.

General Principle	Specific Application to Futures and Options

	Trading
➢ Charters of regulatory agencies should be expressed in terms of economy-wide objectives.	➢ The purpose of vesting power in the ASC to regulate futures and options trading on organised markets is to facilitate the orderly transfer of price risks and enhance price discovery so as to promote establishment of fair prices in both derivative and underlying markets, (including, but not limited to underlying markets for investment products).
➢ Licensing/authorisation regimes directed at "protecting" the interests of consumers, absent any concern about activities affecting the stability of the financial system, should be confined to activities with either: (a) a retail involvement, (b) some fiduciary relationship warranting a form of "fit and proper person" certification, or (c) some clear evidence that it is needed to achieve market efficiency objectives.	➢ Licensing by a government agency of persons conducting a business involving futures and options trading on organised markets is appropriately confined to those conducting a business of entering futures contracts on behalf of other people. Conduct of business rules applying to all users of market facilities, including those purely conducting proprietary trading, can be satisfactorily imposed by an exchange, subject to oversight by a government agency such as the ASC, without the need for licensing by the government agency of proprietary traders (including "locals").

General Principle	Specific Application to Futures and Options Trading
➢ Conduct of business rules which restrict the manner in which transactions may be effected (as distinct from rules as to who can participate) should be imposed only where the restrictions can be demonstrated to enhance the benefits to the broader economy which potentially accrue from those activities or to prevent activities which would detract from pursuit of economic efficiency.	➢ Regulation which proscribes certain conduct by futures and options brokers - eg putting their own interests before those of their clients in the way they effect trades - is justified because it promotes confidence in the fairness of a particular market *and* the specific market activity being regulated (futures trading) should be fostered by regulation (because, by enhancing price discovery, it contributes to orderly transfer of price risks and establishment of fair prices).
➢ Prudential supervision should be linked to participation in the payment system and stability of the financial system. Unless an entity's activities raise these issues, assessment of the appropriate risk appetite for an incorporated business should primarily be the responsibility of an entity's board rather than a government agency.	➢ Some members of a futures exchange are banks whose activities warrant prudential supervision because of their role in the payments system. However, the only aspect of futures and options exchanges' activities - as distinct from the entirety of particular members' activities - which might need to be taken into account by a prudential supervisor concerns clearing and settlement procedures. (*At present, this aspect is treated administratively as the sole responsibility of the ASC as market efficiency regulator rather than of the Reserve Bank as prudential supervisor. Formally, the responsibility is vested in the Treasurer, with the ASC advising the Treasurer on clearing house authorisation in respect of nominated markets)* Other aspects of a futures exchange's activities, namely provision of trading facilities, fit more neatly within market efficiency/conduct of business regulation regime administered by the ASC.

General Principle	Specific Application to Futures and Options Trading
➢ Grouping of financial market activities by reference to the risks inherent in the structure of a product will sometimes provide a useful basis for delineating between regulatory regimes.	➢ A distinction between "derivatives" and (cash market) securities would provide a satisfactory basis for rules concerning separate: (a) (prospectus) disclosure by *issuers* of securities about the merits of a particular *investments* ("securities" provisions) versus disclosure by *intermediaries* of the risks associated with the *mechanism* used to make leveraged investments or other promises without necessarily acquiring title ("derivatives provisions") (b) clearing arrangements for transferring title to securities ("securities" provisions) versus clearing arrangements to transfer credit risks and thereby promote liquidity ("derivatives" provisions).

Part 4: Proposals for Change

The issues faced by the Australian Securities Commission in supervising separate regulatory regimes for “securities” markets and “futures” markets provide useful insights into issues involved in integrating and rationalising regulatory regimes which are currently based on product distinctions.

As the range of financial market activity expands, a question arises in respect of each new activity as to whether the ASC’s role should expand to encompass the new activities. Sometimes this is appropriate and sometimes it is not. It depends on how one characterises the ASC’s role.

If one articulated the ASC’s role broadly and imprecisely - eg. “protecting the integrity of Australia’s financial markets” or “lifting the standards of risk management controls within organisations which undertake investments or are otherwise exposed to risks involving financial markets products” - the ASC’s role will tend to expand automatically to cover the new activities. This would occur whether or not they give rise to exactly the same need for regulation as the other activities which the ASC already regulates.

If the ASC’s legitimate function of facilitating the fairness, efficiency and orderliness of investment markets were interpreted very broadly as a responsibility to ensure that users of financial market products adopt prudent practices, there would be considerable scope for overlap with the responsibilities of either the Reserve Bank (in the case of prudentially supervised institutions) or the board of directors (in the case of other incorporated bodies). The ASC would become a prudential supervisor of many thousands of companies.

Instead, one needs to start at the other end; one needs to look at the two discrete “product” classes in respect of which a regulatory regime has been created (and which the ASC administers) and identify why those regimes exist. Then it may be possible to work out if other financial market products should be regulated in a similar manner to one or other of those two discrete regimes.

The primary objective of regulating “securities” markets is relatively free from doubt: it is to enhance the efficiency with which market structures achieve their objective of efficiently allocating savings to the most productive investments.

By contrast, the primary objective of regulating futures and options markets is less well understood: the historical evidence would suggest that regulation has primarily been introduced to reduce the scope for fraudulent activity. There is not a great deal of evidence that regulation has been introduced primarily in order to enhance the benefits to the economy which futures and options markets generate, notwithstanding the clear evidence that such benefits do result (as outlined in the SIRCA and Allen Consulting Group studies mentioned in Part One).

Whether the emphasis should properly be on fraud prevention/consumer protection or enhancing the benefit to the economy/orderly transfer of price risks (or a combination of these

objectives), a decision to regulate futures markets inevitably poses an issue as to the overlap with “securities” regulation.

Derivatives can be used as part of investment strategies: hence, some of the instruments and objectives of “securities” regulation will be relevant. On the other hand, derivatives can be used for other purposes which have no connection with “securities” regulation: for example, transactions entered for the purpose of hedging risks have no connection with the allocative efficiency objective of securities regulation if the underlying price risks (eg price movements in electricity or wool) have nothing to do with the holding of traditional securities such as shares and bonds.

For example, supervision of trading in wool futures has little to do with encouraging people to invest their savings in the wool industry (rather than in a product where no futures products exist). Instead, it is about encouraging those market mechanisms which facilitate an orderly transfer of price risks, in order that various economic benefits can be realised (eg if producers have greater certainty as to the price that will be obtained, they can increase production).

The major category of issues which a supervisor/regulatory agency needs to address much more closely when derivatives are involved than when transactions in the underlying are involved concern the stability of the financial system.

Whilst the scope for incurring dangerously high exposures is not confined to exposures involving derivatives, market structures have developed in completely different ways in derivatives and cash markets in response to differences in risk profile between derivative and cash market products.

In cash markets, there has not been the same need for exchanges to develop structures which restrict the capacity of participants to assume risks which may lead to defaults. In futures markets, structures have developed whereby members of an exchange can have quite large exposures to the clearing house and vice versa, rather than separate large exposures to other members.

This concentration of risk in the clearing house of a futures exchange calls for exercise of supervisory responsibilities with an eye to the consequences of a clearing house being unable to perform contracts to which it has become a party (eg credit risks being assumed by members of an exchange). By contrast, supervision of a clearing house for cash market transactions is more concerned with operational risks associated with transferring title to particular assets.

In the context in which the appropriate allocation of responsibilities between supervisory agencies is being considered, an issue arises as to which type of agency can best perform the function of supervising the operation of clearing houses or particular types of clearing house.

The traditional approach has been to vest responsibility in the same agency which supervises the relevant exchange. Having the same agency supervise the operations of both a clearing house and the exchange whose trades it clears makes some sense: it recognises that their

systems and procedures need to be closely integrated even if the clearing house is not owned by the relevant exchange.

On the other hand, skills needed to supervise the operations of a clearing house are, arguably, more akin to the skills needed to oversight financial institutions as to the adequacy of their risk management systems than the skills needed to supervise an exchange as to the fairness and efficiency of its trading procedures.

The Reserve Bank (and not just the ASC) has an interest in the financial strength of the clearing house of a futures exchange, especially if the members of that clearing house include banks supervised by the RBA and those banks have substantial mutual obligations arising out of their clearing house membership.

The skills needed to oversight financial institutions - particularly because they can transform their risk profile so quickly through use of derivatives - are skills concerned with assessing the processes by which risks are managed and managerial capabilities.

Furthermore, the type of supervisor where these skills are most needed - a prudential supervisor of those financial institutions whose inability to meet their obligations could have systemic risk consequences - has a legitimate interest in the robustness of clearing facilities in which those institutions are active participants. If large concentrations of counterparty risk can have systemic implications, regulatory attention needs to focus not merely on institutions but on payments and settlement systems.

All of these considerations suggest that the systemic risk supervisor (the Reserve Bank) should have a role which includes oversight of the adequacy of clearing arrangements from a systemic risk perspective.

This need not be to the exclusion of the ASC. Now that the Treasurer is the Minister with responsibility for administering the Corporations Law, the power to authorise the provision of clearing facilities for both cash markets in securities and derivatives markets respectively (not merely derivative markets in securities) is the same Minister to whom the Reserve Bank reports in respect of its systemic risk responsibilities.

Accordingly, even without any legislative changes, the way is open for the Treasurer to look to both the Reserve Bank and the ASC for advice on the adequacy of risk management within clearing houses.

With the unbundling of trading facilities and settlement facilities likely to gather pace (discussed in Part Two above) there is also a need for the systemic risk supervisor to focus on the range of other new market structures, as they develop, for managing credit, market and settlement risks. For example, it is relevant to whether a participating bank has a sufficient capital buffer to meet potential losses from otc derivatives transactions which are netted via multilateral netting arrangements such as a swaps depository, to know how such a depository's procedures reduce credit risk. Similarly, whether or not bi-lateral close out netting arrangements are effective in an insolvency situation is recognised as being an issue of legitimate concern to a systemic risk supervisor.

Trading needs to be distinguished from settlement of trades for regulatory purposes. Trading primarily raises disclosure and fairness (or “market integrity”) issues whereas settlement also raises payment system/reduction of systemic risk issues. The ASC is the logical agency to administer provisions of the former type irrespective of the nature of the financial instrument being traded.

However, where the trading activity is primarily concerned with transferring price risk, functional regulation alone (directed at issues such as protection of client funds) would be insufficient to address the systemic risk issues which could arise. A systemic risk supervisor also has a legitimate interest in the robustness of any of those arrangements - (such as netting or novation of liabilities) in which supervised institutions participate - which could impact significantly on the financial position of the institution. (A market integrity regulator has a legitimate interest in those same arrangements to the extent that they could adversely affect the achievement of fairness, orderliness and efficiency of trading activities.)

All of those considerations suggest that the systemic risk supervisor (Reserve Bank) should have an explicit responsibility to oversight the operation of payment and settlement systems, ranging from bi-lateral netting arrangements through to multilateral clearing involving novation of contracts.

Conclusion

The following factors support conferral of a more explicit responsibility on the Reserve Bank to oversight the operation of all clearing and settlement systems:

- the direction in which markets are moving, with provision of facilities for matching and settlement of transactions no longer being provided exclusively by the same entities which provide facilities for trading;
- convergence of skills needed for supervising financial institutions and supervising management of risks in multilateral netting facilities, namely skills in assessing the processes by which risks are managed and managerial capabilities.