POLICING FINANCIAL SERVICES: FUTURES MARKET REGULATION[1]

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A REPORT TO THE CRIMINOLOGY RESEARCH COUNCIL

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INTRODUCTION

In 1980 the Campbell Committee predicted that "the development of our futures exchange will probably be one of the great financial dimensions of this century".[2] That view has been fully vindicated by subsequent events. During the 1980s the Australian futures industry experienced rapid and sustained growth to the point where today, it is an integral part of the overall financial system. The Sydney Futures Exchange (hereafter SFE) is the ninth largest in the world, and the biggest outside the USA and the UK, with a turnover of almost 12 million contracts annually.

The success or failure of the Australian futures market depends crucially on the appropriateness and effectiveness of the mechanisms through which it is regulated. Futures markets, like financial markets generally, are vulnerable to various forms of abuse and malpractice. These include market manipulation, numerous forms of on and off-exchange fraud, and member and clearing house insolvency. As events in recent years have demonstrated, (the collapse of the Hong Kong Futures Exchange during the 1987 crash, the corruption of the Chicago exchanges exposed by the more recent FBI "sting" operation[3]) a failure of the regulatory regime can have disastrous consequences not only for the market itself, but potentially for the wider economy.

Despite the vital importance of the mechanisms through which financial markets (including futures markets) are regulated, the subject has been given little attention

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2 Committee of Inquiry into the Australian Financial System, Chairman J K Campbell, (hereafter the Campbell Report) AGPS 1981. See also Australian Financial Review 20 Feb 1980.

3 See further below p.2.

in either the legal or social science literature.[4] As former National Companies and Securities Commission Chairman Leigh Masel has observed:

> Surprisingly, notwithstanding the Campbell Committee Report, there has been very little conceptual soul-searching about the future direction of regulation of Australia's capital markets.[5]

This article seeks to redress the balance. While it focuses directly on commodity and financial futures,[6] many parts of the argument have wider implications for financial market regulation generally.

The approach adopted is a broad comparative one, which contrasts the Australian regulatory regime with regulatory developments elsewhere, and asks: how effective are different regulatory mechanisms in achieving their purported public policy

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4 The overall system of regulation, its philosophical underpinnings, policy basis, effectiveness and inadequacies, have never been seriously scrutinised. However, individual aspects of the statutory scheme of futures market regulation have been examined in the pages of this journal and elsewhere. See generally A J Dreise "New Futures Industry Legislation" (1986) 60 Law Inst J 944; E F Frohlich "Some Features and Legal Aspects of Futures Markets" (1986) 60 ALJ 224, "Futures Industry and the Duty of Care to Clients" (1987) 61 ALJ 192; R Giuffre "The Regulation of the Commodity Futures Market in Australia" (1982) 5 UNSWLJ 170; M G Hains "Licensing Implications of the Futures Industry Code" (1987) 3 Aust Bar Review 216, "Stop-Loss Orders: A Critical Analysis" (1989) 10 JIBFL 451, "Churning and Burning: A Futures Cause of Action?" (1989) 63 ALJ 608, "Duty to Execute a Stop-Loss Order" (1987) 61 ALJ 431, "Duties and Obligations of a Futures Broker" (1987) 3 Aust Bar Rev 122; R Markovic "The Futures Broker and Client Relationships in Australia" (1989) 2 Corporate & Business Law Journal Vol 2 Part 1 85, "The Legal Status of Futures Market Participants in Australia" (1989) 7 Companies & Securities Law Journal 82; G Walker "Futures Shock: Corporate Collapse, Malpractice and Fraud in the Australian Futures Industry" (1986) 2 Massey Journal of Asian & Pacific Business.

5 L Masel "The Politics of Regulation" (1985) 37 Professional Administrator 22.

6 For reasons of space, the article does not purport to cover options or the operations of the clearing house. On these issues see further M G Hains "SFE Practice in Clearing Contracts through ICCH Sydney" 1990, 5 JIBFL, 62-67; M G Hains "Options Revisited" 1989, 4 JIBFL, 70-74.

goals? The central argument is that while there are lessons to be learned from regulatory practices in other jurisdictions, it would be a serious mistake simply to "borrow" overseas legislation and to impose it on the Australian market. That market has evolved in a particular financial and political environment, and it has structural characteristics which distinguish it, in crucial respects, from futures markets elsewhere. As a result, a very different system of regulation may be appropriate for the Australian market. To what extent the contemporary regulatory regime is compatible with the characteristics of the Australian market, and to what extent there is a need for reform, are issues which are examined later in this article.

Uses and abuses of futures markets

Futures contracts are essentially binding agreements to deliver or take delivery of a specified amount of a certain commodity at a fixed price at an agreed time in the future. Since the quality, quantity, delivery point and delivery month are all standardised by the exchange on which the transaction takes place, it follows that the only matter for negotiation is the price. Thus one person (a "short") agrees to sell a commodity and make delivery of it in a specified future month. On the other side of the contract, someone else (a "long") agrees to buy and accept delivery of a commodity in the specified future month. In practice the obligation to deliver is usually negated by the seller buying another futures contract with the same futurity date before delivery time -- so that what is really at stake is the difference between the price for which the contract was bought, and the price of the commodity at the time of settlement.

The primary reason for futures trading is to achieve protection against price uncertainty in the cash market, and it is when cash market prices are most volatile that futures trading is heaviest. Futures markets serve a number of functions related to price volatility: in particular they enable the transfer of the risk of price

fluctuation to those better able to bear them (hedging), they act as a guide to the future cash price of commodities (price discovery), as an aid to forward planning and inventory control, and finally as a forum for speculation.[7] The considerable volatility of commodity and financial markets in the last decade (particularly dramatic fluctuations in interest rates and the exchange rate) has generated an increasing awareness in the Australian financial community of the risks associated with fluctuating prices and of the virtues of futures trading as a cost-effective and flexible means of managing such risks.[8] As a result, the futures market has become an increasingly important component of Australia's financial system.

While futures markets provide very substantial economic benefits, they also have their darker side. Billions of dollars worth of financial transactions are processed through them each day under an arcane system known as "open outcry", which makes surveillance, regulation and social control extremely difficult. The opportunities for deception, fraud and outright criminality are considerable, the potential rewards for such activity are enormous, and the chances of getting caught are minimal.

Broadly, futures markets are vulnerable to three types of malpractice or abuse: manipulation, fraud and macroeconomic externalities created by the possibilities and repercussions of insolvencies. Manipulation of prices is potentially the single most important abuse to which futures markets are susceptible. Manipulation involves "the use of a dominant position in a market in order to distort prices from

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7 See further C. Veljanovski "Organised Futures Contracting," (1985) International Review of Law and Economics, 5, 28-38.

8 For example, the share price index futures contract allows a portfolio manager to change his exposure to the share market quickly and without the transaction costs associated with buying shares. Similarly the futures markets in bank bills and Treasury bonds enables borrowers and lenders to set interest rates ahead of time on future commitments.

the equilibrium that otherwise would have resulted."[9] Manipulation is most likely to occur as a contract approaches maturity because outsiders generally avoid delivery. As a result, the number of "open positions"[10] diminishes, and it becomes easier for one trader to hold a substantial proportion of those remaining. If the concentration of positions held by a particular individual or group becomes excessive, then "squeezes"[11] or "corners"[12] - the most common forms of manipulation - become possible.[13]

Fraud within futures markets can take a variety of forms. The most important distinction is between "frauds masquerading as legitimate commodity

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9 G Gemmell "Regulating Futures Markets: A Review" in M E Streit Modelling, Managing and Monitoring Futures Trading (Blackwell, Oxford, 1983) 307. See generally P M Johnson and T Hazen Commodities Regulation (2nd ed Boston, Little Brown, 1989); F Easterbrook "Monopoly, Manipulation, and the Regulation of Futures Markets" (1986) 59 J. Bus. L. 103, 117-8.

10 Futures contracts for the delivery month entered into but not yet liquidated.

11 A squeeze occurs when a "dominant long" (buyer) apparently wishes to take delivery and the open interest exceeds the deliverable supplies of the commodity. This will force the "shorts" (sellers) to pay a higher price than would occur in an unmanipulated market.

12 A "corner" occurs when a manipulator buys up available supplies in a particular spot market, gaining a virtual monopoly on the supply of that commodity, and at the same time owns "long" futures contracts in excess of the available amount of the commodity. Again, as the futures contract approaches maturity, the manipulator can threaten to take delivery. This will force those who are short in futures to offset their contracts at a premium or to buy supplies from the manipulator at a price he or she dictates, in order to resupply them to the manipulator at the futures price.

13 Other forms of manipulation include promulgation of misinformation (eg news of the president's "death") and market rigging. On manipulation generally, see R T Byrd "No Squeezing, No Cornering: Some Rules for Commodity Exchanges" (1979) 7 Hofstra Law Review 923-952; P M Johnson "Commodity Market Manipulation" (1981) 38 Washington and Lee Law Review 3, 725-779.

investments"[14] and legitimate transactions which involve a fraudulent element. Put another way, the distinction is between "off exchange" and "on exchange" fraud. The most notorious forms of "off exchange" fraud are those which involve bucketing or leveraged currency operations. In the case of the former, the dealer, although purporting to act as broker, in fact takes a principal position against the client (that is, the orders are not placed on market) and then manipulates the contract to his advantage. With the latter, the dealer does not generally represent that he trades on a recognized futures exchange, but takes a principal position against his client, with the result that a loss to a client is an equivalent profit to the company. Losses are therefore allowed to mount and the client's contracts closed out while he is in a loss situation.[15] "On exchange" fraud primarily involves the use by floor traders of a variety of techniques to avoid competitive order execution, to secure better transaction prices for themselves at the expense of others, and to cheat, or through other criminal practices, exploit their outside customers or each other.[16]

Finally, the potential volatility of futures prices makes the insolvency of a broker or trader a continuous possibility. Such insolvency may result not only in loss of clients' funds and loss of confidence in the market, but could also lead to further economic collapses down the line, involving, in an extreme case, the insolvency of the exchange's clearing house itself, with devastating consequences not only for the futures exchange, but for the entire economic system. This indeed is the scenario

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14 D Chaikin "Commodity Investment Fraud" (1985) 6 Company Law 263.

15 M G Hains "Off Market Futures Fraud" in B Fisse and R Purvis (eds) White Collar Crime and Corporate Regulation: Current Perspectives, 1991 (Federation Press, Sydney)..

16 The principal trading abuses that may take place in the pits are discussed in P M Johnson and T Hazen Commodities Regulation 1989 (2d edition, Vol 3, Boston: Little, Brown).

which Hong Kong faced in October 1987.[17] These contingencies are usually described as "macroeconomic externalities".

All three types of malpractice and abuse quite clearly existed in the Australian market, at least prior to enactment of the Futures Industry Code 1986, which established the contemporary regulatory framework. As the then Commonwealth Attorney-General, Senator Evans, pointed out, in introducing that legislation:

> Experience with the administration of the New South Wales Futures Markets Act, the manner in which non-members of the Sydney Futures Exchange have promoted and conducted their business and the failure of a number of futures brokers have clearly indicated the need for Australia-wide legislation in such cases as the licensing of brokers, conduct of business, trading conducted through overseas futures exchanges and market manipulation.[18]

These problems of manipulation, fraud and insolvency cause direct financial losses to individual investors, against which they are ill-equipped to protect themselves. They can also have serious repercussions that extend to producers and consumers generally. The latter "often bear the ultimate burden of increased commodity prices that result from fraudulent and manipulative market practices."[19] Moreover, such practices have a generally detrimental effect on futures markets themselves,

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17 See further N Gunningham "Moving the Goalposts: Financial Market Regulation in Hong Kong and the Crash of October 1987" (1990) 15 Law and Social Inquiry 1-48.

18 Australian Financial Review, Aug 8 1983. The case for regulation has been further developed in the American literature. See for example H S Houthakker "The Regulation of Financial and other Futures Markets" (1982) 7 Journal of Finance, 481-91; J M Stone "Principles of the Regulation of Futures Markets" (1981) 1 Journal of Futures Markets 117-121.

19 L G Demartini "Fraud in Commodity Futures Trading" (1981) 34 Vanderbilt Law Review 1349, 1351.

weakening their stability, undermining investor confidence, reducing levels of trading, and in extreme cases, jeopardizing the viability of the market itself.[20]

Since the unassisted market has proven incapable of addressing these problems, there is a perceived role for outside intervention.[21] That intervention can be seen to have two principal objectives. The first is to ensure that futures contracts are "orderly and fair" in the sense that "the rules, customs and usages of the market apply equally to all participants, there are no collusive dealings and all participants have equal access to the competitive processes of the market, and no person or group of persons engage in manipulative practices that impede the competitive pricing of futures contracts."[22]

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20 A number of other arguments are sometimes put forward in favour of regulation, but these are often in the nature of "straw men". For example, it has been suggested that futures markets have an inclination towards monopoly (difficult to justify in a global market); that they encourage gambling (so does much else); that they lower farm prices (never substantiated) and that they increase price volatility. This last argument is perhaps the strongest, and program trading in futures markets is alleged to have exacerbated the market collapse of October 1987. Whether it did so, remains unclear. See generally Streit, op cit, 21. On the cause of volatility during the 1987 Crash, see J Markham and R Stephens "The Stock Market Crash of 1987" (1988) 76 Georgetown Law Journal, 1933-2043.

21 A viable futures exchange could not exist without some form of regulation. Few would be prepared to trade on a market where contracts might not be honoured (and where the potential insolvency of one's trading partner might preclude effective enforcement), where there were no guarantees against being defrauded and few, if any, effective remedies if such fraud took place, where traders might form coalitions with a view to exercising market power, and where market rigging and a host of other manipulative practices might be rife. Such a market could provide no stability or predictability of trading, would involve very high transaction costs, and would soon wither away. This was recognised very early in the history of futures trading. See M Abolafia "Self-Regulation as Market Maintenance" in R G Noll (ed) Regulatory Policy and the Social Sciences Berkeley, U Of Cal Press, (1985) 317.

22 National Companies and Securities Commission Policy Statement: Futures Industry Act and Codes - Role of the Commission, issued 23 March 1987, revised 21 March 1990, cited in Australian Securities Law Reporter, CCH, 60-210.

Second, to ensure that futures brokers and advisers are, and are seen to be, persons with whom participants in the market may deal with confidence.[23] In achieving these objectives, a balance must be achieved which allows commerce to thrive while effectively curbing market abuses.[24] How the Australian legislative framework seeks to achieve those objectives and this balance is an issue to which we now turn.

The Legislative Framework

The regulation of the Australian futures industry is now governed by Chapter 8 of the Corporations Law,[25] which substantially adopts the provisions of the Futures Industry Code 1986. In respect of the first objective stated above (orderly and fair markets), s.1137 requires that a futures exchange "to the extent that it is reasonably practicable to do so, take all steps, and do all things, necessary to achieve that goal. Chapter 8 goes on to impose a number of wide-ranging obligations on market participants for the same purpose. In particular, it prohibits:

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23 Ibid.

24 The question of the optimal degree of government involvement in market surveillance and associated regulatory activities in the United States, particularly in financial futures markets, has been canvassed in P Cagan "Financial Futures Markets: Is More Regulation Needed?" (1981) Journal of Futures Markets 1; K C Froewiss "Comment" 1981, 1, Journal of Futures Markets.

25 In New South Wales v Commonwealth of Australia (1990) 90 ALR 355, it was held that the Commonwealth lacks legislative power under s.51(xx) of the Constitution to make laws for the incorporation of trading or financial corporations. As a result, the Corporations Act 1989, was amended by the Corporations Legislation Amendment Act 1990. The modified scheme is now known generically as the "Corporations Law". See further H A J Ford and R P Austin Principles of Company Law Supplement to the 5th edition, 1991, Butterworths.

- Insider trading where a futures contract relates to securities of a body corporate.[26]
- Trading intended to create an artificial price (market manipulation such as squeezing or cornering to ramp the market).[27]
- False trading or market rigging.[28]
- False or misleading statements or the dissemination of information likely to induce persons to deal or to affect the price.[29]
- Fraudulently inducing persons to deal in futures contracts[30] or otherwise to defraud a client.[31]
- Disseminating information to the effect that the price for dealing in futures contracts is likely to rise or fall or be maintained because of transactions that contravene ss 1259-1262.[32]

In respect of the second objective (protecting the interests of clients in their dealings with brokers and advisers), Chapter 8 is even broader. It seeks to protect customer interests by requiring:

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26 Part 8.7 Div 1.

27 Section 1259.

28 Section 1260.

29 Section 1261.

30 Section 1262.

31 Section 1264.

32 Section 1263.

- All Australian futures brokers to be licensed and establishing membership of an approved futures exchange or futures association as a prerequisite for licensing.[33]
- Regular preparation of documents relating to client's trading, monthly statements[34] and full records of brokers dealings on their own accounts.[35]
- Client's funds to be kept in a segregated account separate from the brokers funds.[36]
- Brokers to explain the nature of futures contracts and to disclose the risks attached to futures contracts to clients prior to trading on their behalf.[37]
- That all futures contracts must be made on a recognised exchange.[38]
- Brokers to follow the rules set down in Chapter 8 "for transmission of clients' orders to the futures exchange trading floor, execution on the floor, and subsequent allocation of orders to particular clients."[39]
- The auditing and supervision of broker accounts.[40]

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33 Section 1142, and see further M G Hains, "Licensing Implications of the Futures Industry Code" op cit. See also "Amendments to the Licensing provisions of the Securities Industry Code and the Futures Industry Code" Butterworths Company Law Bulletin, No. 17 of 1989, para 263.

34 Sections 1206, 1207.

35 Section 1208.

36 Section 1209.

37 Section 1210.

38 Part 8.2 Div 1.

39 "A Guide to Australian Futures Legislation" Sydney Futures Exchange, 1990, p.2 paraphrasing section 1266.

40 Part 8.5.

- The establishment of a fidelity fund for the purpose of providing compensation to any person suffering pecuniary loss because of defalcation or because of fraudulent misuse of money or property by a contributing member of the fund.[41]
- Prohibiting certain forms of abusive behaviour such as bucketing and churning.[42]

Chapter 8, in conjunction with the Australian Securities Commission Act 1989, provides a statutory framework to facilitate co-regulation of the futures industry by self-regulatory organisations and the Australian Securities Commission (hereafter ASC). The self-regulatory aspect might notionally be provided both by futures exchanges and by a separate futures association. However, in practice it is the exchange[43] which is responsible almost exclusively for the self-regulation of the Australian futures industry. This outcome is a product of the structure of the legislation itself. First, it regulates futures exchanges, in order to ensure that markets are operated in a fair and orderly manner. Second, it regulates futures organisations, being organisations of futures brokers whose task is to regulate the activities of their members in dealings with clients. However, the legislation then

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41 Part 8.6.

42 Section 1258. For a definition of bucketing see p.7 above. Churning is the excessive trading of an account by a broker for the purpose of generating commission without regard to the needs and objectives of the client. See further M G Hains, "Churning and Burning", op cit.

43 Like the SFE, the very much smaller Melbourne based Australian Financial Futures Market Pty Ltd (AFFM) also acts as a self-regulatory organisation with respect to its members. To date the SFE and the AFFM are the only futures exchanges to have been approved under SS 1126(2) of the legislation. Both exchanges have been established systems of business rules and procedures designed to provide for public disclosure of trading, disciplinary procedures and limits on public exposure to contract liabilities. The AFFM to date trades extremely thin volume and comprises an extremely small proportion of total futures industry in Australia. For those reasons, this article focuses exclusively on the SFE.

blurs this distinction by providing that in order to obtain a futures brokers licence, a person must establish membership of either an approved futures exchange or an approved futures association.[44] In practice, no such separate futures association has evolved, and the Sydney Futures Exchange acts both as an approved futures exchange and as an approved futures association, thus performing both the traditional role of an exchange (maintaining an orderly market) and that of a futures association (client protection).[45] One significant result is that the SFE regulates all the futures broking activities of its members, whether in Australia or overseas.[46]

The self-regulatory activities of the SFE are intended to be complemented by those of the ASC, the new federal government watch-dog. However, the ASC's role, as previously of the National Companies and Securities Commission (NCSC) is essentially one of oversight rather than direct intervention. Indeed the most striking feature of the Australian regulatory regime under the Corporations Law (as under the Futures Industry Code before it) is the low degree of government involvement.

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44 Ss 1144A, 1145 and see s 9 definition of "futures organisation".

45 The provisions of Chapter 8 are reinforced by the Exchange's own regulations, particularly its Business Rules, which provide a detailed and comprehensive code of conduct for its members. The failure of a member to comply with the Business Rules is prima facie "behaviour prejudicial to the interests of the public or the Exchange, or its members or the conduct of any market" and is a basis for disciplinary action against a member. Fines of up to $250,000 may be imposed and the member's membership suspended or terminated.

46 In Australia, it has been noted that trading must generally take place on an approved futures market, and overseas client business must be placed on a recognised exchange.

Certainly the ASC has power to ensure that futures markets operate in an orderly and fair manner.[47] It also has wide powers to inspect and investigate, hold hearings and intervene in the market to ensure that transactions are effected in accordance with the legislation and with the business rules of the self-regulatory organisation, and to detect illegal futures markets.[48] Further, it must apply licensing policies such that futures brokers are subject to the prudential controls of the self-regulatory organisations.[49]

However in pursuing the objectives of the legislation the Commission is guided by the principal that futures markets should be forced to operate with only as much regulation as is necessary to ensure that they function in an efficient, competitive and orderly manner.[50] Accordingly, as a 1990 NCSC policy document expressed it:

> the legislation places the primary responsibility for the proper regulation of futures business on the relevant self-regulatory organisation constituted for this purpose. The Commission will therefore intervene in a matter concerning a futures exchange, futures association or a clearing house only where those bodies are unable to act in the matter, or fail to do so to the satisfaction of the Commission, or where there is evidence of criminal misconduct on the part of a participant in the market.[51]

Given the deregulatory environment in which the Futures Industry Code was developed, and the strong influence of the futures industry itself in shaping it, this

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47 Section 1138.

48 Australian Securities Commission Act 1989 Part 3.

49 The Corporations Law Part 8.3.

50 National Companies and Securities Commission Policy Statement: Futures Industry Act and Codes - Role of the Commission, op cit.

51 Ibid.

strong self-regulatory emphasis is hardly surprising. The underlying assumption is that the industry itself is best placed both to identify and curb abuses and to balance commercial viability with the need to maintain investor confidence. In this respect, the scheme is not unusual. Self-regulation is the pre-eminent mechanism for regulating financial markets in almost all developed countries, and Australia is no exception.[52]

Self-Regulation versus government regulation

Few would dispute the need for some form of regulation in order to curb the sorts of abuses described above. The more contentious questions are how extensive that regulation should be and what form it should take. The central and most controversial issue is whether, or to what extent, government should be involved directly in the regulatory enterprise, or whether all, or at least most, matters can be safely entrusted to self-regulatory organisations.

Those arguing in favour of self-regulation maintain that it offers considerable advantages. Specifically it is said that it offers speed and flexibility in administration; that regulation is initiated by, rather than imposed on, the controlled group, increasing the likelihood of compliance; that it goes beyond the "letter of the law" by providing ethical standards of conduct and behaviour;[53] that practitioners can bring a detailed knowledge both to the setting of standards and to

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52 The self-regulatory aspects of the Futures Industry Code are even more extensive than they are with respect to other aspects of the Australian financial services industry.

53 Campbell Report op cit 21.11.

the identification of breaches; and that self-regulation is far cheaper for the tax-payer.[54]

However, the potential shortcomings of self-regulation are also readily identifiable and well known. As former NCSC Chairman Henry Bosch has pointed out:

> "There will always be temptations for those who are framing the regulations to so order their affairs that outsiders are excluded and the profits of insiders maximised. There will always be a danger than standards will be set at a comfortably low level and that investor protection will take second place. When breaches of standards have been identified there will be a danger that punishment will be secret and mild, particularly if the offending firm has played a major role in the [Self Regulatory Organisation.][55]

Many commentators, examining the workings of self-regulation in practice, have concluded that the disadvantages of self-regulation heavily outweigh its advantages, and they have documented the adverse consequences which may follow from a substantial reliance on self-regulation.

The most striking evidence comes from the American markets, where early attempts at self-regulation were an abject failure.[56] Indeed, the creation of the Securities and Exchange Commission (SEC) in the 1930s was a direct response to the gross inadequacies of the exchanges in policing the activities of their members.

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54 H Bosch "The Essential Role of Self Regulation" The Australian, 2 Nov 1990.

55 Ibid. See also Campbell Report, op cit 21.12.

56 See generally, R W Jennings "Self-Regulation in the Securities Industry" (1964) 29 Law and Contemporary Problems 630-690; R Lejeune "False Security: Deviance in the Stock Market" in P Adler and P Adler (eds) The Social Dynamics of Financial Markets (New York, JAI, 1984); P Levin "The Limits of Self-Regulation" (1967) 67 Columbia Law Review, 603-644; "Report on Regulatory Reforms by the Industry Regulation Committee of the American Bar Association" 54 American Bar Association Antitrust Journal 503-525.

The 1930s legislation, however, still left the exchanges with very considerable self-regulatory responsibilities, which they continued to discharge without enthusiasm or effectiveness.[57] In 1973, a Senate Securities Sub-Committee Report echoing many earlier reports, concluded that the "inherent limitations [of] allowing industry to regulate itself" were "well known", and noted in particular:

> "that natural lack of enthusiasm for regulation on the part of the group to be regulated, the temptation to use a facade of industry regulation as a shield to ward off more meaningful regulation, the tendency for businessmen to use collective action to advance their interests through the imposition of purely anti-competitive restraints as opposed to those justified by regulatory needs, and a resistance to changes in the regulatory pattern because of vested economic interests in its preservation."[58]

Turning specifically to futures markets, there is recent evidence to suggest that self-regulation works no better here than it does in other financial markets. In Hong Kong, the much criticised closure of the stock and futures exchanges during the October 1987 crash was the product of abuse of power on the part of those responsible for self-regulation of the exchanges. Moreover, widespread illegalities and mismanagement of the Futures Exchange and a complete failure of its self-regulatory mechanisms resulted in its potential collapse in the wake of the crash, threatening Hong Kong's entire economic system, and forcing the Government to finance a HK$4 billion bail out package.[59]

In the USA, the world's two largest futures exchanges, the Chicago Board of Trade and the Chicago Mercantile Exchange are currently under a cloud as a result of a

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57 See further J Seligman "The Historical Need for a Mandatory Corporate Disclosure System" (1983) 9 Journal of Corporation Law 1, 54.

58 Securities and Exchange Commission, Report of Special Study of Securities Markets, H Doc No 95, pt 4, 88th Cong. 1st Sess, 692-728 (1964).

59 See further Gunningham (1990) op cit.

two year undercover sting operation involving FBI agents posing as traders. The initial indictments in 1989, totally 1276 pages, charged that corrupt traders used a variety of complex schemes designed to steal money from customers by circumventing the open outcry system, and to evade federal income tax. For example, the evidence is that brokers tipped off accomplices of customer plans; that brokers traded with accomplices at prices that benefited the latter but cost the customer money; that brokers conspired to rig prices; that brokers manufactured spurious losses in order to evade income taxes; that locals conspired with brokers to take trades at a loss where brokers had made errors (e.g., failed to execute on time) on the basis that they would be paid back through money skimmed from customer accounts. The US Attorney General, Richard Thornburgh, described the offences as "the largest of their kind in the world."[60]

In both cases, subsequent investigations have not only identified major shortcomings in the operation of self-regulation, but have also recommended a substantial degree of direct government intervention in the affairs of the industry. In Hong Kong, the recommendations of the Hay-Davison committee are largely academic,[61] since the events of October 1987 so shattered investors confidence in the local futures market that today the market has almost completely collapsed. In the USA, the picture is more complex. The US futures markets were already the most heavily regulated in the world, with the Commodity Futures Trading

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60 Australian Financial Review, 4 August 1989, 3. See also New York Times, 3 August, 1989.

61 "The Operation and Regulation of the Hong Kong Securities Industry" Report of the Securities Review Committee (Chairman I Hay-Davison) Hong Kong, May 1988.

Commission having considerable powers.[62] Even so, there was still considerable discretion given to the exchanges to regulate their own affairs,[63] and it is this discretion which Congress is now seriously re-examining. Current proposals before Congress include measures intended to severely curtail and constrain industry self-regulation and to ensure that it operates in the public interest rather than merely in the interests of its members.

This history of self-regulation overseas might lead one to conclude that the Australian system of futures market regulation, which, as indicated earlier, is heavily reliant on self-regulation, is highly suspect and vulnerable to abuse. However, such a conclusion would be premature. The effectiveness or otherwise of self-regulation will depend crucially on structural (and cultural[64]) variables which may differ markedly between jurisdictions. While under some structures, self-regulation may fail catastrophically (as in Hong Kong), under others it may prove a

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62 The Commodity Exchange Act 1936, as amended, and the Commodity Futures Trading Commission Regulations empower the CFTC to set speculative limits, daily price limits and reporting requirements, to register and licence traders and to vet new contracts. CFTC also has the power to change delivery conditions, restore orderly trading and made regular investigations. In addition, it can direct exchanges to take certain specific actions.

63 Under the Commodity Exchange Act 1936, as amended, the exchanges themselves (referred to as boards of Trade) have a central role in self-regulating their activities and their members. Under the Act an exchange must provide, "for prevention of manipulation of prices and the cornering of any commodity by the dealers or operators on such board". (7USD#7(d)) This gives rise to a variety of duties and powers for exchanges that affect contract design, position sizes of members, and market surveillance,. Additional exchanges rules typically are designed to limit abusive trading practices unrelated to manipulations. Finally, an exchange has the responsibility for screening potential members to assure that they meet certain standards of personal integrity and financial soundness.

64 The importance of culture is examined in Gunningham op cit.

viable, perhaps the most viable, approach – at least when complemented by adequate government oversight.[65]

In later sections of this report, it will be argued that there are good reasons to believe that the structural conditions of the Australian market, do make self-regulation a viable regulatory approach. This is not to suggest that it will work perfectly (nor will government or any other mechanism), nor that it is free from significant shortcomings. However, self-regulation in Australia is exposed to strains and pressures which are far less severe than in many other markets, and in consequence, it is less vulnerable to abuse, and better able to deal with such abuses as do occur. Moreover, the shortcomings of the existing system are not irremediable, and the article concludes with a number of specific proposals made for reform.

Australian Market Structure

In this section, I wish to identify the particular features of Australian market which make it less susceptible to abuse than either its Hong Kong or United States counterparts, and far more amenable to effective social control by means of self-regulation. The suggestion is not that futures market participants in Australia are any more or less honest than elsewhere, but simply that certain features of the Australian market provide an equilibrium, a set of checks and balances and create disincentives for dishonesty and deceit.

The first, and most striking feature of the Sydney Futures Exchange, and of the Australian market is its almost wholly institutional nature. Some 95 per cent of all

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65 See further pp.42-48 below.

futures business comes from institutional investors[66], and the retail element (particularly amateur speculators) is very small indeed. This is in marked contrast to the American market where the speculative element is substantial[67] and where the exchanges actively solicit such business. Again in Hong Kong, the speculative element immediately prior to the crash, was very large indeed, with estimates approaching 85 per cent of all market activity accounted for by individuals.[68]

The essential point is that professionals, as compared to amateurs, are largely aware of the risks of futures trading, have a considerable degree of sophistication in how they use the market, are far better able to identify when they have been cheated, and are in an immeasurably better position to take action (formal or informal) against those who have cheated them.[69] For example, a large institutional player may simply transfer its substantial account from any broker whose practices it finds unsatisfactory, or transfer its trade to another market should the exchange itself fail to meet its requirements. The fact that the same players are repeatedly involved in dealing with each other may also result in a mutual self-interest in trust and fair dealing, in contrast to the diffuse and anonymous nature of much speculative trading by individuals.

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66 See "Role and Net Benefit of the SFE". A Report by Cooper and Lybrand, Consultants, Dec 1989, summary p 3.

67 Over 25 per cent of volume is estimated to be speculative.

68 Gunningham (1990) op cit, 43.

69 These points are developed in more detail in "Self-Regulation in Financial Markets: A Comparative Perspective" forthcoming.

Second, the Australian futures market is comparatively small. There are 29 "full" Members of the SFE, some 308 Associate Members, and 71 local members.[70] It trades about 12 million contracts a year. In contrast the Chicago Board of Trade trades 143 million futures and options contracts a year, while the Chicago Mercantile Exchange trades some 78 million contracts a year. The SFE trading pits themselves are smaller, and have far fewer active participants, than those of either Chicago or Hong Kong.[71] Size and activity level are both important to the effectiveness of social control. A pit with 40-60 active traders is comparatively easy to monitor. Traders themselves are able to detect abuses perpetrated by their fellows, and can either report them or, more commonly, take informal reprisals (e.g. to ostracise the trader concerned). As one experienced trader put it: "the SFE floor is so small that [traders] would be crazy to be tempted to use their advantageous position to their own benefit", because such abuses would be easily detected by the broking firm that initiated the order and perhaps also by exchange officials.[72]. In marked contrast, there may sometimes be more than 400 traders in the more active Chicago pits, and both surveillance by the exchange and informal social controls by traders themselves become problematic, if not impossible.

Third, in the United States exchanges, many traders are "independents" rather than employees of broking houses, taking orders on commission while also trading their own accounts (dual trading). The temptations to which dual traders are

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70 The current Business Rules provide for three classes of membership: Floor members (with full access to the trading floor); locals (specialist floor traders trading on their own behalf); and associate members (who must trade through floor members, but at a concessional commission rate).

71 The Hong Kong market is now moribund. The appropriate point of comparison is prior to the market crash of October 1987.

72 Australian Financial Review 8 May 1989, 61.

subjected are strong,[73] and many large commercial users of futures would prefer to buy seats on the exchange and have all trades executed by employees who are prohibited from trading their own accounts. However, in Chicago, and some other exchanges, there is a strong tradition against using employees, and in some pits, regular traders refuse to trade with them, thereby deterring their use. At the SFE, in contrast, all full floor members of the exchange use employees, rather than independents to make trades on their behalf. Those employees are not allowed to execute business for their own accounts, although the firm may execute an order for the employee, treating it like another customer order. As a result of this structure, trading abuses such as front-running[74] while not impossible, are less likely than on exchanges such as Chicago.[75]

Fourth, the most important single reason for the trading abuses revealed by the FBI investigation in Chicago, was to compensate for "out-trades". These are trades where there has been some confusion as to who is buying or selling, miscommunications as to price, size of order, and so on. The rules provide that it

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73 For example, a dual trader may be tempted to "bucket" a customer order, taking the opposite side of that order into his own account, or into an account in which he or she holds an interest, rather than trading the customer order competitively. The customer gets a bad price on his order while the floor broker or his accomplice profit at the client's expense. Similarly a dual trader may "trade ahead", trading for his own personal trading account (or tip off a third party accomplice to make a trade) before he executes a large order for a customer.

74 A significant problem at the SFE had allegedly been front-running (trading ahead of customer orders) from the "back office". However, now much more business is phoned from the customer, directly to the trading floor, where employed traders have less opportunity to engage in it.

75 This statement must be qualified in two ways. First local traders trade primarily for their own accounts but may take "give up" business from their nominating broker (e.g. if his own employees were too busy). Second, some employees of brokers are permitted to trade house accounts, taking a proportion (usually 10 per cent) of profits, and this practice, may generate a diluted temptation for abuse.

is the broker, not the customer, who must bear out-trade loss. For independents, such losses can be crippling, and according to the FBI, many traders resorted to cheating customers, in order to recoup such losses. Out-trades are only discovered after the buy and sell orders are "matched". By this time, the market may have moved considerably, and the error may be very expensive indeed. However, at the SFE, the practice of "continuous clearing" means that errors will be discovered very soon after they occur, so that generally they can be rectified before the market has moved substantially, thereby minimising losses and the temptation to cheat customers. Again, the fact that at the SFE it is the employing firm, rather than an independent broker, who must bear the loss, also reduces the pressure to cheat.

Fifth, the nature of the floor members and their clients renders the possibility of insolvency (and with it, the potential loss of client funds and "macroeconomic externalities") far less likely in the Australian market than in many other markets. There are two main reasons for this. One is that floor members themselves are mostly banks or large broking firms whose vulnerability to bankruptcy is very low. The other is that their clients are primarily institutions which, since they are more involved in hedging than in speculation,[76] are therefore themselves less likely to experience financial difficulties in respect of their futures transactions. This is in marked contrast to the Hong Kong market where many members were small and undercapitalised, and many clients were small retail speculators. During the crash, many clients refused to pay their brokers, and many brokers themselves had insufficient capital to bear these losses, so that the clearing house and guarantee

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76 This point is made by Tilley, op cit, 36.

fund (themselves manifestly underfunded) were left to bear the burden of their defaults.[77]

Finally, the organizational structure of the exchange itself may have a crucial bearing on the efficacy or otherwise of self-regulation. The interests of futures markets participants are rarely homogeneous. More commonly, relations are characterized by competitive rivalry and conflicting interests (eg, the interests of large brokers as against locals trading solely on their own accounts, of individuals as against institutional investors, of floor professionals as against all others). It is not uncommon for a single group or a coalition, to dominate exchange decision-making, and to use the rules of the exchange and its regulatory mechanisms, as a forum for expressing and attaining their needs.[78] In these circumstances, self-regulation, far from serving the public interest, serves the interests of one set of elites over others.

However, this outcome is not inevitable, as the experience of the Sydney exchange demonstrates. At the SFE, as elsewhere, there are differences of interest, and a single group dominates. This group is made up of the institutions (the merchant banks, major trading banks, independent brokerage firms and stockbrokers) which make up most of the 29 floor members of the exchange. This group has both formal power (5 of the 10 seats on the board of the exchange) and informal power (because it provides the exchange with the overwhelming majority of its business). In contrast, the 79 or so local traders and the numerous and diverse associate members, have little or no say, either formally or informally, in the exchange's

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77 See further Gunningham, (1990) op cit, 16-19.

78 In recent years, this has been the case both in Hong Kong and in Chicago. See Gunningham (1990) and Policing the Pits, forthcoming 1992.

decision-making processes.[79] However, whereas in many other markets (including Hong Kong and Chicago) there is a large gap between the public interest and the self-interest of the dominant group, in Sydney this gap is considerably smaller, with crucial implications for the potential efficacy of self-regulation.

There are a variety of reasons why this is so. The institutions which dominate the SFE are principals trading for the treasury desk of their own organization or large brokerage houses acting mainly for big institutional clients. Some of them take on both functions. These players all have a long term commitment to the viability and success of the SFE. Those acting as principals rely on futures market as a central component of a broader financial strategy as described above. Only if that market is highly liquid can they trade efficiently on it. Brokerage houses have an equally strong interest in generating high trading volume for the commissions they charge on each trade are the basis of their profitability.

All these institutions are acutely aware that the reputation of the exchange is crucial to its continuing success. Futures markets suffer from an image problem. Their history is often riddled with scandal and they are still treated with considerable suspicion by investors. A failure to curb abuses, a reputation for market manipulation, or a history of member insolvencies, is likely to deter investors and reduce liquidity, threatening both the efficiency of the market (increasing the bid-ask spread) and the profitability of its members. Moreover, given the implications of futures trading for the broader financial system, any failure to curb abuses incurs the risk of more direct government regulation. This is

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79 The composition of the board, the main decision-making body, reflects the power structure. There are 5 representatives of floor members, 2 members elected by the locals and associate members, 2 independent directors and the Chief Executive. Informally, they are equally powerless. As one local noted, "if I complained - no floor member would clear my trades. No one would trade with me."

widely feared by traders as likely to bring with it unnecessary and costly restrictions and rigidities, inhibiting innovation and leading to a loss of business to other, more competitive markets.[80]

Those groups which control the exchanges of other jurisdictions have not necessarily had the same self-interest in preserving the integrity of the market. For example, in Hong Kong, prior to the 1987 crash, many of the most influential members of the exchange were very much in the market for a "quick turn", rather than the "long haul", and showed little interest in protecting the long term viability of the exchange.[81] The massive abuse perpetrated in the Hong Kong market during that period was closely connected with this fact. Again, in Chicago, according to the FBI investigation the "locals" who dominate decision-making, particularly at the Board of Trade, were under intense pressure to cheat clients in order to survive, and used their power over exchange decision-making to block tighter controls on their behaviour.[82] Clearly, the nature of the dominant group on an exchange plays an important role in determining the exchange's approach to self-regulation.

Even where exchange decision-makers do see the virtues of maintaining a "clean" market, and act upon it, there may still be considerable problems of deviance, because exchange members have a strong temptation to behave opportunistically.

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80 It is largely for these reasons that the SFE and its floor members actively supported the introduction of the Futures Industry Code in 1986. The Code enabled them to remove the off-exchange bucket shops, which were tarnishing the reputation of the entire industry, and also to give users of the market, especially overseas investors, confidence that they had the protection of a comprehensive regulatory framework.

81 See further Gunningham 1990, op cit.

82 See further Gunningham Policing the Pits, forthcoming 1992.

That is, while they urge all others to comply with the rules for the common good, their own interest (eg, to maximise profits) may lead them to seek gain by surreptitious non-observance of those same rules. This is the very familiar "public goods" problem which haunts most markets. The behaviour of traders in Chicago, exposed by the FBI investigation, is a contemporary example of such opportunism at work.

Again, the Sydney market is at least to some extent, an exception, because the institutional players who dominate the SFE have, by and large, little incentive to engage in the sorts of abuses that have so tarnished markets elsewhere. This may be illustrated by considering the three major aims of futures market regulation identified earlier (fraud, manipulation and insolvency) and examining the interests of the dominant group of institutions with respect to each of them.

Off-exchange fraud, such as the activities of bucket shops, brings the entire futures industry into disrepute without providing any conceivable benefit to the institutions or to any other exchange members. Unsurprisingly, the 1986 legislation, which largely eradicated such activity, was strongly supported by the exchange and its members. Institutional members (as compared to small brokers in Hong Kong, or locals in Chicago) equally have little to gain from "on-exchange" fraud. In the case of those who act as principals, such fraud is likely to be perpetrated against them by their employees. With the single exception of inter-market front running,[83] they have no incentive to engage in such activity themselves. In the case of brokerage houses trading on behalf of others, they risk losing that trade (and much more besides) if they are even suspected of fraudulent activity and have far more to lose by such activity than they have to gain.

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83 For example, an institution may be about to place a large order on the stock market. Knowing it will move the price of stock index futures contract, it may trade on the futures market ahead of its stock market transaction.

Manipulation is a potentially serious problem in any market and a partial exception to the above analysis. Only very large players (institutions and a few individuals with vast resources) have the financial capability to engage in it. Certainly some institutions in Australia, as elsewhere, have behaved opportunistically and succumbed to temptation.[84] However, institutions are also vulnerable as the victims of manipulation, and at the organizational level, and certainly within the decision-making processes of the exchange, there is no incentive to support such activity. No market with a reputation for manipulation can flourish. Any successful manipulation attempt will reduce the volume of trade in the relevant contract, and therefore the interests of all exchange members.

With respect to insolvency, the large majority of floor members are large institutions who have little difficulty complying with margin, capital adequacy and other anti-insolvency requirements imposed under the futures industry legislation or by exchange or clearing house rules. Again, the insolvency of a member would have adverse repercussions for the whole industry. Institutions are happy to prevent such an occurrence and are only minimally disadvantaged by the rules themselves. Indeed, they may see some competitive advantage in further increasing capital adequacy requirements in order to handicap their smaller competitors.

All these factors suggest that the Australian market is less vulnerable to fraud, manipulation and insolvency than many other markets, that players have disincentives to engage in market abuses, that when they do engage in them, they are more readily detected than elsewhere and that the exchange decision-makers themselves, in many circumstances, have the appropriate incentives to curb

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84 See for example, the manipulation of the 10-year bonds contact in September 1988. "SFE investigates squeeze" The Australian p 17, 20 Sept 1988

abuses. From this one might predict that the local market would be relatively "clean", that there would be a lower level of abuse than elsewhere, and that such abuse as exists would be manageable by the self-regulatory mechanisms of the exchange.

The empirical evidence, while meagre[85] (only the FBI has the resources to conduct an adequate investigation) is consistent with the analysis presented above.[86] In the past, the most serious problem was off-exchange fraud resulting from the activities of bucket shops and leveraged currency and operators described earlier.[87] These schemes have been largely eradicated with the introduction of the Futures Industry Code, which not only channelled all legitimate transactions onto the exchange, but also, through the licensing requirements, made it easier to identify and prosecute unauthorised dealings. Unsurprisingly, the "legitimate" industry, and the SFE in particular, was more than happy to see the removal of these illicit operations, which had served to tarnish the reputation of the industry as a whole.

Today, under the Corporations Law, as under its predecessor, the Code, there is no evidence of any widespread or systematic criminal activity such as has existed in recent times in Hong Kong or Chicago. While there are accusations of fraudulent

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85 There is no adequate statistical basis on which to make direct comparisons between markets. Moreover, much criminality may simply go undetected and unreported. To date, only the FBI has had the resources and the will to conduct an adequate investigation of trading abuses.

86 The author conducted over 50 interviews with a broad spectrum of industry participants in 1989 and 1990. While reasons of space preclude description of that research in the present article, the comments below are based on that research unless otherwise stated. Some of the data from that project are analysed in Appendix 1, attached.

87 Above p.7.

practices in individual instances, such as "front-running" from the "back office", the general view of industry participants, including customers, (the potential victims) is that the SFE is comparatively clean (or even "positively angelic") as compared with most others[88].

Manipulation is a perennial problem in futures markets and the SFE is no exception. Moreover, as a relatively small market, it is necessarily more vulnerable than a large and highly liquid market where enormous capital would be required to launch a successful manipulation. The SFE has been no more successful than any other exchange in preventing such manipulation.[89] Arguably, since many sophisticated market participants themselves get caught by a successful manipulation, it is hard to see how the exchange (or a government regulator) could be expected to do any better.[90] Perhaps more significant is the fact that the SFE, whose reputation is seriously damaged by such events, has taken firm action after the event to prevent its repetition, primarily by changing the contract specifications. As indicated earlier, major players may also take their own informal action, either in the form of reprisals against the offending institution, or "voting with their feet" and boycotting the offending contract. The most recent and best known manipulation of the Sydney market, the ramping of the 10 year bond

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88 P Rennie "Now Futures Trade Links to Share Plays" Business Review Weekly 7 December 1989, 52. Interviews conducted by the author with over 50 market users (including potential victims) support the general view that the market is relatively clean.

89 This is best explained by the difficulties in distinguishing a manipulation from a legitimate trading strategy, and of taking effective action when this ploy involves a brief but intensive effort to shift the price, rather than the gradual build up of a position. In these circumstances the only effective action may be to redesign the contract specifications.

90 A manipulation usually involves a manipulation of the physical (eg, stock) market as well as of the derivative market (futures) and it is beyond the jurisdiction of the exchange to intervene in the former.

contract in September 1989, bears out these points.[91] This event provoked not only a major NCSC investigation, but also a large downturn in the offending contract, followed by SFE action to alter the way the contract was priced.[92] It also produced a considerable backlash by major victims against the perpetrator.

Finally, and crucially, there is the issue of insolvency and "macroeconomic externalities". Certainly during the earlier stages of the exchange's history, this was a serious problem, and the collapse of a number of commodity brokers during the early 1980s exposed substantial loopholes in the regulatory protection of investors.[93] However, not only has the nature of the membership shifted substantially since that time (away from small independent brokers to large institutions), but the enactment of the Futures Industry Code provided the exchange with the power to impose much more stringent financial controls on unscrupulous former "off-exchange" operators.[94] In recent years, the various forms of protection against insolvency established by the SFE itself,[95] have proved

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91 It has been alleged one player tried to influence the close-out price of the futures contract by buying all the available physical stock of the key January 1998 bond and therefore boosting the bond price. As the futures contract does not exactly equate with a physical bond, the contract's closing price is based on the yield of a chosen 10-year bond - usually the key trading stock. From this action, the alleged ramper made substantial capital gains.

92 From the end of 1989 all bond futures contracts were made physically deliverable rather than cost-settled. With a physically deliverable contract, the futures close-out price is based upon a basket of long dated bonds, therefore making the possibility of cornering the market far more difficult.

93 See Australian Financial Review 13 April 1981; 16 April 1982; 3 Aug 1983; 31 Aug 1983; 31 Aug 1984.

94 See for example, the case of Southern Cross Securities Australian Financial Review 19 Jan 1982.

95 These include capital asset backing, the fidelity fund arrangements, and the independence of a large internationally backed clearing house (ICCH).

more than adequate to their task. Perhaps the best evidence of this is how the SFE withstood the market crash of October 1987, without experiencing a crop of insolvencies or pressures on the fidelity fund. Once again, structural factors, specifically the nature of the SFE floor members and their clients and the self-interest of the exchange and its clearing house in avoiding the consequences of insolvencies, does much to explain the success of the existing self-regulatory mechanisms.

Limits to Self-Regulation

The structural variables considered above suggest that there is relatively less opportunity for serious abuse at the SFE, that checks and balances constrain participants from engaging in such abuse, that abuses, when they occur, will be easier to detect by the self-regulatory authorities and that in most, but not all respects, the decision-makers (the board and executive of the SFE), have a self-interest in curbing abuses. As a result, the Australian futures industry has both the incentive and the means to generate a viable system of self-regulation.

However, even in this favourable environment, self-regulation does not perform in an entirely satisfactory manner. One inherent problem of self-regulation by members of an organization is that it tends to be operated by the members, for the members. So long as the interests of the membership coincide with the public interest this causes little difficulty. Unfortunately, where they do not, the history of self-regulation suggests that organizations often behave more like private clubs than public utilities and that the broader public (or customer) interest will be sacrificed to that of the membership. Indeed, that history is littered with examples

of special interests (i.e. those who control decision-making within the exchange) dominating decision-making and exploiting their position for their own ends.[96]

In the previous section it was argued that at the SFE, there is considerable overlap between the public interest and that of the dominant member group, and that this serves to mitigate the grosser problems experienced by some self-regulatory organizations. However, in some areas there still remains a considerable disparity between private and public interest. In this section we identify the extent of that disparity, its consequences in terms of major failings in the self-regulatory mechanism, and how those failings might be mitigated or overcome.

Potential problems arise in three areas: the setting of standards; surveillance and compliance action and enforcement. In respect of standard setting, the current arrangements are reasonably satisfactory. Over the years the SFE has tightened and extended its business rules,[97] and these self-regulatory efforts are complemented by the comprehensive legal framework now contained in Chapter Eight of the Corporations Law. Both these developments are consistent with the SFE's self-interest in protecting its reputation, and with assuring off-shore and domestic investors that they can safely trade the Australian market, and more recently with being granted the status of an "approved market" by the US

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96 The role of the New York COMEX during the silver squeeze of 1979-80 of the Hong Kong Futures Exchange during the crash of 1987, and of the Chicago Board of Trade during the alleged soybean futures squeeze of July 1989 are three well-publicized examples. There are numerous others. See P Sarnoff Silver Bulls (Arlington House, Connecticut, 1980) Ch4; Gunningham, (1990), op cit; R W Jennings, "Self-Regulation in the Securities Industry," (1964) 29 Law & Contem Probs 630; Securities and Exchange Commission, Report of the Special Study of Securities Markets, H.Doc.No 95, pt.4, 88th Cong., 1st Sess. 692-728, at 696. See also L B C Gower Review of Investor Protection (London, HMSO, 1982) 11.

97 As set out in the Articles of Association, the By-Laws and the Trading Etiquette.

authorities for the purpose of trading SFE contracts in the USA without the need for registration there. Indeed, if there is a frequently voiced criticism of the current standards, it is that they overregulate.[98] Very few respondents in this study expressed serious reservations about the existing rules and there is every indication that future reform will (and should) focus on stronger penalties (and perhaps, tighter surveillance) as opposed to changes in the rules themselves.

The SFE has various methods to monitor compliance and detect possible trade practice abuses. First, there is actual physical observation of trading in the pits, particularly at the opening and closing of trading, when markets are most active and there is more opportunity for abuses to occur. Exchange officials maintain that floor observation is important because by maintaining contact with the floor, observers are able to detect trade practice abuses and listen for related rumours.

Second, there is the computerised audit trail system which reconstructs trading by time of trade, by matching various information fed into the system, and analyzing the data to detect possible abuses. This system is rapidly becoming the exchange's chief surveillance mechanism. It is intended to reconstruct the trading activities of members and member firms so as to detect patterns of conduct that might indicate rule violations, thereby isolating questionable trades and leading to the detection of trade practice abuses. The issue of computerised surveillance is highly complex

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98 Specifically, the Futures Industry Code (now the Corporations Law, Chapter Eight) borrows considerably from the philosophy of stock market regulation and seeks to protect "widows and orphans" as well as the international investors. Since over 95 per cent of the market is institutional, and small retail customers are largely discouraged, it may well be that some rules to protect the retail sector (risk disclosure statements, client agreement forms, contract notes) are inappropriate for the vast majority of transactions that take place at the SFE.

and technical and cannot be properly examined here.[99] It may simply be noted that although the SFE has taken a number of steps to develop a surveillance system, so far many of those efforts are still at the developmental stage. In particular, the current system is incapable of providing and adequate audit trail because of deficiencies and inaccuracies in the transaction time records.[100] As a result, it is incapable of detecting much floor trading abuse and much remains to be done to bring it up to the level of the more sophisticated American systems.[101]

The SFE has its own internal compliance staff responsible for detecting and investigating trade practice violations. However, these staff do not themselves take disciplinary actions. Rather, their investigations generate written reports, and cases involving potential rule violations are submitted to the appropriate exchange disciplinary committees. There is little doubt that between 1985 and 1988 the exchange took a conscious decision to engage in active, even aggressive compliance action. It assembled a team of professionals, gave them considerable autonomy, and facilitated a vigorous system of scrutiny of its members affairs, which has resulted in recommendations for disciplinary action for "technical" breaches as well as for more substantive offences.

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99 On the problems of developing adequate audit trails see General Accounting Office, Futures Markets: Strengthening Trade Practice Oversight, Washington DC, 1989.

100 Floor brokers are required to time all transactions and to record them on chits. However, there is no mechanism to ensure the accuracy of the time recorded.

101 Other (market) surveillance activity is concerned to detect unusual trading patterns and market manipulation, while the general audit program was devised to comprise periodical audit of member accounts, to ensure compliance with capital adequacy segregation of accounts, client disclosure forms, etc.

It is at the level of enforcement that the SFE's current self-regulatory regime is subject to most serious criticism and where there is the greatest disparity between public and private interest. Because of the privacy surrounding disciplinary hearings and penalties, it is impossible to obtain adequate statistical information. However, there is a widespread view that the SFE's disciplinary mechanisms[102] are unsatisfactory in a number of respects. First, there is a perceived reluctance to impose penalties.[103] Second, where penalties are imposed, they tend to be lenient,[104] even in the case of quite serious offences.[105] Third, there is considerable secrecy concerning the circumstances surrounding disciplinary action. Very little information seeps into the public arena, raising concerns about accountability and the need for justice to be seen to be done. Finally, as a result of the first and second factors above, the surveillance and compliance staff of the exchange become discouraged, sometimes demoralised, believing that however carefully they assemble a case, the exchange is unlikely to take firm and effective action.

There are a number of reasons for the general laxity of enforcement. One is the close relationship between many members of the board of the exchange (the main disciplinary body) and those who appear before it. The problem is particularly

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102 Small disciplinary issues are addressed by the exchange's Committee of Inspection and Audit (CIA), which can fine up to $1,000. However, more serious matters are referred to the board if the CIA decides there is sufficient evidence to justify pursuing a case.

103 A number of respondents familiar with the compliance and vetting operations of the exchange made this point.

104 Certainly this view has been taken by the NCSC as well as by members of the compliance staff, on a number of occasions.

105 Even breaches short of fraud, eg, failure to adhere to the margin requirements could potentially have serious consequences.

acute when disciplinary action is being taken against one of the 29 floor members of the exchange. Five of the 10 members of the board are themselves floor members. There is a tendency to feel that "there but for the grace of God go I", and a consequent reluctance to punish fellow members caught breaking the rules or to impose a penalty commensurate with the offence. As one senior representative of a floor member put it:

> "There's a bit of a feeling that we're all in this together and so we won't be too hard on our mates."

As a result of this club-like atmosphere, there is a general perception that

> "If a major broker went before the board charged with a major offence, if you asked me would I be confident that the board would come to a sensible conclusion I would probably say no."

This is far less of a problem when the offender is an associate member or a local, for here there exists an arms-length relationship and a power differential between the parties. According to one observer: "The small fry are easier to get at, less litigious. You can pick on them more easily." Similarly, the board has less difficulty imposing a severe penalty if the offender is in receivership and its principals have fled the country.[106]

Another concern of the board is that their actions might be misinterpreted by potential customers of the exchange. Specifically, they are fearful that if they do impose heavy penalties, then this might be taken as an indication that the market generally, is tarnished. As one senior member of the board noted:

> "The fact that fines have been imposed doesn't do the industry's name with the public any good. It's bad promotional material."

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106 See for example, penalties imposed in 1988 on Nizal Investments Pty Ltd.

This attitude is accompanied by a marked reluctance to disclose precisely what disciplinary action the board has taken, and why. At present only minimal information (name of offender, section breached, penalty imposed) is available, and even this is circulated only to other members of the exchange and to the ASC.

Finally, members of the board fear retaliatory legal action on the part of those being disciplined, and for this reason are reluctant to impose penalties such as might justify subsequent legal challenge. One particular case in which the exchange and some individual members of the board were challenged successfully on natural justice grounds, has had a salutary effect on board members generally.[107]

Further problems face the exchange's executive, which itself has a major role in all stages of the regulatory process. There can be no doubt that the executive, and the Chief Executive in particular, have taken considerable steps over the last six years to protect the integrity of the exchange and to reassure investors (particularly large overseas customers) that the exchange has not only rigourous legal controls, but also a vigorous and independent compliance program.

As one member of the SFE executive put it:

> "We took a conscious decision to aggressively enforce our compliance rules because we saw it of benefit in establishing ourselves as well regulated and to demonstrate to the United States and potential customers in Australia that we were well regulated ...".

The fact that the SFE was the first exchange to be granted the formal approval by the US authorities necessary to market its contracts in the USA, bears testimony to the success of this policy.

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107 Kingston Commodities Pty Ltd v Sydney Futures Exchange, unreported, Supreme Court of NSW, No 4398 Powell J, 26 Sept 1984.

However, the executive inevitably faces a number of tensions in trying to reconcile its twin roles as industry regulator and commercial entrepreneur. In its latter role it must ensure the industry's expansion and profitability. This means, above all else, increasing the volume of trade, for it is in these terms that the executive's success is ultimately judged.[108] There is often a conflict between the action necessary to maintain a tight and effective regulatory regime, and that which will maintain or increase volume, at least in the short term. For example, like the members, the executive may be reluctant to take action against a large and powerful institution, for fear of losing that member's business to another market, and it may be reluctant to expose some serious wrongdoing because a scandal might also drive business away.

In summary, the gap between public interest and private interest can become substantial both for the board and the executive, and on occasion a long term concern with the reputation of the exchange (and by implication with enforcing the rules) may be sacrificed to more immediate short term ends. However, it has also been argued that, given the structure of the Australian market, in many other respects self-regulation works reasonably well and that its failings, unlike those of some other markets, are neither intractable nor inherent in the structure of the market. In any event, government in Australia has shown little inclination to intervene directly in the affairs of the futures industry, and it remains unlikely that it could command the resources or the expertise to do so effectively. Indeed, governments throughout the western world have recognized the impracticability of substituting direct regulation of their securities and futures markets for the

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108 At a more mundane level, the executive has a direct financial interest in volume because it takes a commission for each trade executed on the exchange.

functions presently performed by self-regulatory organizations.[109] For the foreseeable future, self-regulation remains the most viable and effective form of social control. The important question, therefore, is how it might be reformed and strengthened, rather than how it might be dismantled and replaced.

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109 Even the world's best funded government regulator of futures, the US Commodity Futures Trading Commission, has been severely criticised for its incapacity to understand and deal with market problems, for its inability to keep competent staff and for behaving like a "sleeping pygmy".

Recommendations for Reform

There are a number of reforms which, if implemented, would go a long way to alleviating self-regulation's present shortcomings. These reforms take two forms. First, ensuring the more efficient functioning of self-regulation itself. Second, ensuring more effective government oversight. With regard to the former:

- The power to discipline exchange members should be removed from the board and given to a separate Business Conduct Committee, at least half of whose members are independent, and at least one of whom is a representative of the ASC.[110] The independent members should be persons capable of providing impartiality and relevant experience. The operating premise is that public representatives will be less likely to face conflicts of interest and will be more likely to enforce exchange rules against exchange members.[111]

- Members of disciplinary bodies who have been found guilty of major rule violations should be prohibited from serving on such bodies for significant periods of time.

- Exchange compliance and surveillance staff should be permitted to request the board/Business Conduct Committee to review decisions of the Committee of Inspection and Audit (which at present screens cases and makes recommendations to the board). The intention here is to preserve

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110 Under present arrangements, two of the ten members of the board are independents, as currently is the Chairman.

111 The boards of both the New York Stock Exchange and the Amex have included 50 per cent of public representatives since 1972.

"the balance between staff and committee members necessary for the self-regulatory process" and to assure the public "that [the] staff has sufficient authority to perform its regulatory function".[112]

The exchange should be required to publish full details of disciplinary actions including the particulars of the offence, and the penalty imposed. Only where there is full disclosure of disciplinary action is the rest of the market (including potential customers) in a position to exercise informed choice as to whether to use a particular broker. Moreover, publicity gives potential offenders a considerable disincentive to illegal behaviour, even if the disciplinary body itself fails to impose a substantial penalty. Finally, publicity would serve to make the disciplinary body accountable in that its actions would be subject to public scrutiny.

The self-regulatory organisation should be granted qualified privilege, thereby mitigating the fear of legal action which presently deters exchange disciplinary bodies from imposing serious penalties on their members.[113]

These measures would do much to reassure outsiders of the fairness of exchange disciplinary actions, they would make it much more difficult for insider deals to be struck behind closed doors, and they would reduce conflicts of interest. In general, they are consistent with recommendations for reform currently being considered

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112 "The Future of Futures" Intermarket June 1989, 47.

113 Such a request was made by the Australian Stock Exchange in 1990.

both by Congress and the Chicago Exchanges, following the FBI investigation of 1987-1989.[114]

The limits of self-regulation in its present form can also be offset by more effective government oversight. It has long been recognised that even where self-regulation is a viable form of social control, it is unlikely to be optimal unless the self-regulatory organisation (SRO) is subjected to government oversight by a body with broad reserved controls available if the SRO does not adequately carry out its responsibility for protecting investors. Such a body is intended to act as a countervailing force, preventing the exchange leaning too far towards commercial expediency, at the cost of regulatory rigour. In a famous statement in 1938, then SEC Chairman William Douglas described the desirable relationship between the exchanges and the government regulator as follows. The exchanges, he stated, "should be so organised as to be able to take on the job of policing their members so that it would unnecessary for government to interfere". However, the government must retain an important residual power, like a shotgun behind the door: "kept ready for use but with the hope that it would never have to be used".[115]

Unfortunately, in Australia, the shotgun has never been loaded. In 1989-90 the NCSC budget was a derisory $7 million dollars, less than half of the National Crime Authority and on the same level as the Fishing Industry Research Trust and

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114 See in particular Commodity Futures Improvements Act 1989 (HR 2869) and the Report of the House Committee on Agriculture (No 101-236).

115 Douglas's collected speeches on finance are in W Douglas Democracy and Finance, James Allen (ed) Port Washington, N.Y. Kennihat Press, 1969.

ACTION buses in Canberra.[116] The NCSC generally has been severely understaffed, subject to massive backlogs, and at times, to political interference. The very modest proportion of its total budget which the NCSC felt able to devote to Futures, was grossly inadequate to prod the exchange into action, to demand changes in its enforcement practices, to intervene directly, or to bring its own disciplinary actions.[117]

The inadequacy of the NCSC's role and resources has been belatedly recognised by government in the wake of a number of scandals in other parts of the financial services industry. The new Australian Securities Commission, with an annual operating budget of $107 million dollars, almost 50.5 million of which has been earmarked for enforcement, is likely to be a much stronger force than its tame predecessor.[118] Certainly its vastly increased resources and greater powers are to be welcomed, though how it will respond to the futures market remains to be seen. It is to be hoped that that response will include:

. direct intervention in matters beyond the jurisdiction of the SFE, such as intermarket fraud or manipulation involving both physical (stock) and derivative (futures) markets;

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116 See generally H Bosch The Workings of a Watch-dog (Heinemann, Australia 1990).

117 Ibid.

118 See for example "From Blueberry to Corporate Pie" Australian Financial Review 20 Oct 1989.

- in respect of enforcement, the prosecution of those believed guilty of serious breaches (eg, of fraud or manipulation) and the pursuit of substantial penalties.[119]

- regular rule enforcement reviews of the SFE to ensure that it is complying with its responsibilities under Chapter Eight of the Corporations Law and under its own Business Rules. These reviews should focus particularly on whether the exchange's inspection and enforcement programs are adequate to assure compliance by their members. Where deficiencies are identified, the ASC would direct the SFE to analyze and take appropriate corrective action.

However, it must be recognized that such recommendations are unlikely to be implemented by the ASC in the short term, for a variety of sound practical reasons. First, the ASC, like its predecessor, has great difficulty recruiting staff with the necessary background in and understanding of the futures market, to take effective oversight action. Second, there are many aspects of the Australian financial market that present far more immediate and serious dangers than do futures, and it is unlikely that adequate resources will be diverted from those areas to futures market oversight. Finally, the complexity of many futures (and securities) cases and the enormous expense of litigating them, means that out-of-court settlements are likely to remain the norm.

Conclusion

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119 In the USA the recent sentencing of Michael Milken to 10 years jail for violating federal securities law and tax law, was clearly intended to have general deterrence implications. In Australia, the seeming difficulty of the courts in coming to terms with complex commercial crimes, and their reluctance to impose substantial penalties, are serious impediments to the success of an enforcement based strategy.

Self-regulation has been, and seems likely to remain, the principal means of regulating the Australian futures market. I have argued that the effectiveness or otherwise of self-regulation will depend crucially on a number of structural variables which may differ markedly between jurisdictions, and that the conditions of the Australian market do make self-regulation a viable regulatory approach. Specifically, the Australian market is less vulnerable to fraud, manipulation and insolvency than many other markets, the players have disincentives to engage in market abuses, when they do engage in them, they are more readily detected than elsewhere, and exchange decision-makers themselves, in many circumstances, have the appropriate incentives to curb abuses.

However, this is not to suggest that self-regulation is free from significant shortcomings. In respect of enforcement, in particular, self-regulation has not worked well. There is evidence of a "private club" relationship between members, which has been to the detriment of the public interest. However, these shortcomings are neither fundamental nor irremediable, and a number of recommendations are made for reform. If implemented, these would do much to ensure that the Australian investors maintain confidence in the integrity of the market. Such integrity is essential not only for the protection of customers, but also for further industry growth.

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