

REGULATION OF THE COMMODITY FUTURES MARKET IN AUSTRALIA

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Trading in commodity futures is a form of speculation which is experiencing increasing popularity with the general public. This ever expanding interface between the futures market and the public has focused attention on the adequacy, or otherwise, of the regulation of commodity futures in Australia. In order to formulate an opinion as regards this question it is necessary to review the functioning of the market in Australia. Past, present and proposed regulatory systems can then be validly examined in the light of some common problems and abuses existing in the market place.

In contrast to the fundamentally self-regulatory nature of Australian regulation is the scheme adopted in the United States to cope with their massive trillion dollar futures markets. After analysing the merits and demerits of the American approach and its applicability to the Australian market, conclusions can be drawn and recommendations made on what action is necessary to improve the regulation of the futures market in Australia.

I. THE FUNCTIONING OF THE COMMODITY FUTURES MARKET IN AUSTRALIA

1. What are Commodity Futures?

The Futures Markets Act 1979 (N.S.W.) section 2 defines a "commodity futures contract" as "a contract the effect of which is that one party agrees to deliver to the other party at a specified future time a specified quantity of a specified commodity at a specified price payable at that time". Futures trading is the sale of these contracts by competitive open outcry. The legality of a futures contract is at present unknown, but for the discussion at hand it can be assumed that the contracting

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procedure is valid.¹ A contract, once made, can be satisfied only by delivery or by offset.² Very few futures traders actually accept or make delivery when the contract matures. Most have offset their commitment at some time prior to the last day of trading in the particular delivery month. In fact, less than 2% of all futures contracts result in delivery. This is to be contrasted with the physical market for commodities where delivery is the norm. In the physical market, rather than being standardised, the terms of each transaction are determined through private negotiation between the parties. The Sydney Futures Exchange sets down tight specifications for the standard futures contract subject matter. These specifications are partly aimed at discouraging the use of the futures market as a delivery market.

2. *The Purpose of a Futures Market*

It is most often said that the primary purpose of a futures exchange is to give producers of various commodities, and merchants in those commodities, a means of hedging³ against rising and falling prices (sometimes as much as eighteen (18) months hence). This, it is said, has a long term effect of stabilising prices at retail level with its consequent benefit to consumers.⁴ Others, while acknowledging the undoubted nobility of such a purpose, point out that the provision of a new and sometimes lucrative speculation medium may also be an attractive by-product.

Futures markets re-allocate marketplace risks for physical commodities from those who deal in the physical commodities to speculators who are more tolerant of price risks. This assumption of risk is not usually discouraged because it is realized that the hedger, the investor and the speculator are all needed in the market to provide the necessary liquidity, depth and resilience for successful operating.⁵

3. *The Development of Australia's Commodity Futures Market*

The Sydney Futures Exchange⁶ was formed in 1960 as the Sydney Greasy Wool Futures Exchange, and until 1975, wool was the only commodity traded. Today, the exchange provides facilities for futures markets in wool, gold (1978), silver (1981)⁷, fat lambs (1981) fresh frozen boneless beef (1979 — suspended January 1981 for lack of trading), export bullocks (1982), live cattle (1975), interest rates (1979 — 90 day bank accepted bills), U.S. dollars (1980), Japanese Yen (1980 — suspended

1 Appendix I infra.

2 'Offset' is an equal and opposite transaction, the buyer selling a contract or the seller buying a contract.

3 'Hedging' is where unsold stock is covered by the sale of a futures contract and vice versa. Therefore, offsetting commitments can be employed to minimise the impact of an adverse price movement. In a typical hedge a producer might contract to sell December wool at a certain amount. When December arrives, he could liquidate his position and sell his wool at auction in the physical market. Any profit or loss made in the futures market would be approximately balanced by the loss or profit in the physical market. Thus, hedgers use the market principally as a marketing and price insurance tool.

4 Interview with Stephen Calder, Publicity and Education Manager, Sydney Futures Exchange.

5 J. Broadbent, "Making the Best of Interest Rate Futures", *Rydges*, Feb. (1980), 119.

6 The Sydney Futures Exchange, being Australia's only futures exchange, is in reality, a national exchange.

7 There was at first worry about the short supply of the metal. However, concern has levelled out with the falling of gold and silver prices.

January 1981 for lack of trading) and pounds sterling (1980 — suspended February 1982).⁸

The Sydney Futures Exchange Ltd (S.F.E.) is a non-profit company limited by guarantee. The S.F.E. is made up of twenty six members⁹ which are companies rather than individuals. Membership also extends to associate members (418 as at 5 March, 1982). Only floor members are permitted to transact business on the floor of the exchange. Associate members transact business through floor members at half the normal rate of commission.

Since 1969, clearing house services have been provided for the S.F.E. through an agency of the International Commodities Clearing House Ltd (I.C.C.H., Sydney Branch). The I.C.C.H., a London based company dating from 1888, also provides clearing services for the Hong Kong, Kuala Lumpur and Paris exchanges. The I.C.C.H. was recently transferred to a consortium of six London clearing banks and the approval of the Bank of England was a precondition to this arrangement. The present, better capitalised owner will doubtless be able to provide more than adequate clearing services for the gold and proposed financial futures markets due to open in London sometime in 1982.

All floor members of the S.F.E. must be members of the I.C.C.H. However, the I.C.C.H. is an independent entity. Brokers are directly liable to the I.C.C.H. for margin deposits, additional margins and settlement losses incurred by their clients.¹⁰

4. *Some Legal Relationships in the Market*¹¹

A multitude of diverse legal obligations arise within the futures market. The primary obligations are concerned with the client-broker relationship and the broker-I.C.C.H. relationship. A floor broker by express agreement and also by virtue of his membership of the I.C.C.H. is personally liable to the I.C.C.H. The clearing house in turn guarantees the performance of every futures contract (any other contractual relationships are contentious). In general, the I.C.C.H. articles tend to recognise only the client-broker and broker-I.C.C.H. relationships as practically enforceable.

The client-broker relationship is one of agency and as a result the client is obliged to indemnify the broker for any loss. The relationship also has fiduciary aspects relating to moneys and securities held by the broker. Another fiduciary duty exists to open or close out contracts strictly in the order of receipt.¹² Apart from this, the broker's duty is to exercise execute orders on good faith.¹³ Often brokers and clients on the S.F.E. vary this relationship by special agreement.¹⁴

8 With the U.S. experience in mind the S.F.E. is now looking to set up a stockmarket index contract. The new contract would provide portfolio managers with a revolutionary new hedging tool as well as enabling speculators to wage bets on future moves of the whole market.

9 One floor membership will soon be up for sale given the proposed merger between two existing floor members, AML Finance Corporation Ltd and Elders Commodity Futures Pty Ltd.

10 For the role of the I.C.C.H. in the contracting process see Appendix I, *infra*.

11 *Id.*

12 See text accompanying footnotes 29, 30, 31, *infra*.

13 See *Option Investments (Aust) Pty Ltd v. Martin* [1981] V.R. 138 where it was held that a broker closing out a defaulting client's position, was entitled to select a time of sale which minimized his loss. Although under a duty to protect his client's interest, he was also entitled to protect his own interest (now codified in by-law G3(b) of S.F.E. Ltd).

14 Major clients often enter into a special trading contract with their floor member.

5. *The Unique Nature of a Commodity Futures Market*

The greatest similarities between the functions of a futures broker and those of a stock broker is in the name itself. The market concerned differs in many respects:

- (a) The small amount of deposit margin in the futures market allows speculators to gain significant market leverage from their investment;¹⁵
- (b) commodity speculators look only to price gains and losses while securities investors may be interested in dividends, options, splits and proxies;
- (c) the speculative nature of most commodity trading demands that traders change positions rapidly and often;
- (d) selling short is not only legal but is often recommended in the futures market; and
- (e) the main interest of many futures brokers lies not in acting as a broker for clients but in trading on their own account.

Unlike the stock market which depends upon sporadic 'boom' conditions, the futures market 'booms' continually in its own right. That is, when dealing with futures, profits can as easily be made in a falling market. Consequently, the attraction for the speculator lies in the market's ongoing spectacular profit potential. By the same token, it is no secret that around 85% of speculators in Australia lose their money, a percentage that is in line with the United States' figures.¹⁶

There has been tremendous growth in the market since gold was introduced as a commodity in 1978. This, along with the fact that the market is extremely volatile, has meant that potential for abuse in the market has also grown. Also, some floor members such as Darlington Futures Ltd have become more and more visible to the public. For these, and other reasons, regulation continues to be a key issue in today's commodity futures market.

II. THE REGULATION OF THE COMMODITY FUTURES MARKET IN AUSTRALIA

1. *Introduction*

The regulatory system in Australia has closely emulated the approach of the United Kingdom. Because of the relatively small scale of futures trading the U.K. regulatory system is an informal one. It relies basically on self-regulatory mechanisms and gentle coercion from the Bank of England. In Australia, however, the ever escalating participation by the public has made the futures markets more akin to the American commodity markets. The U.S. futures markets, as will be seen later, are the most highly regulated futures markets in the world.

15 High leverage is what attracts speculators to the market (more often than not with disastrous results). The largest losses occur when paper profits are used to finance further trade ("Pyramiding").

16 G. Richards, "Futures Trouble in the Trading Ring", *Australian Business*, August 1981.

2. *The Pre-February 1982 Australian Regulatory Framework*

On the forming of the Sydney Greasy Wool Futures Exchange Ltd¹⁷ the then members drafted the first set of articles and by-laws to regulate the market. Hence, regulation in the early years of the Australian market was achieved purely by means of a system of self-regulation within the ranks of the members of the exchange. The early members also being engaged in the physical wool business, were generally well known to each other, and this was reflected in the comparatively loose regulations then in force.

Amendments to the articles and by-laws were made from time to time but the overall structure of the regulations remained unchanged until recently. This was so despite the dramatic changes that were occurring in the market by virtue of its growth, the ever increasing number of commodities traded, and the emergence of the investing public as an important user of the market.

The first major regulatory development occurred in 1979 with the passing of the Futures Market Act (N.S.W.)¹⁸ which, among other things:

- (a) Sets out the criteria that a Minister must apply in deciding whether to approve the application of a body corporate to become a futures exchange (section 3);
- (b) requires a futures exchange to provide "such assistance to the commission" as is reasonably required so as to enable the Commission to perform its function and duties under the Act (section 5(1));
- (c) requires a futures exchange to notify the Corporate Affairs Commission (C.A.C.) of any disciplinary action taken against a member (section 5(2));
- (d) gives the C.A.C. full and free access to the records of the futures exchange and its clearing house (section 5(3));
- (e) enables the Commission, or "a person aggrieved", to apply to the Supreme Court to have a futures exchange's business rules complied with (section 6);
- (f) creates offences and fines ranging from \$500 to \$1000 (sections 5(4) & 9(1)); and
- (g) enables the Commission or, with the approval of the Minister, any other person to initiate proceedings under the Act.

The Act therefore establishes the C.A.C. as a watchdog¹⁹ over the self regulatory process which continues to control the market. It cannot initiate changes but can only disallow that which it considers to be inappropriate change. Its power is not great and is also rarely exercised.²⁰

The Articles and General By-Laws of the S.F.E. were substantially amended in a lengthy process involving twenty to thirty drafts. The new regulations became effective as from 1 February, 1982. The Article and General By-Laws of the S.F.E. prior to that date provided for:

¹⁷ The name was changed to the Sydney Futures Exchange Ltd in 1975.

¹⁸ Another reason for the Act was that the exchange wanted to deal in currency futures contracts, which, rather than being settled by physical delivery would be closed out by cash settlement and might therefore be interpreted as being merely a wager and thus unenforceable by virtue of the Gaming and Betting Act 1912. Section 7 of the Futures Market Act 1979 (N.S.W.) provided the exemption sought.

¹⁹ A "watchdog" and opposed to a "bloodhound".

²⁰ There have been no formal proceedings as yet under the Act. The power of access, conferred by s.5(3) is thus, untried. The practical effectiveness of such a power is doubted given that the interchange of employees, the flow of information, and the general collegiate relationship between the S.F.E. and the C.A.C.

- (a) The organisational structure of the membership and board of the exchange;
- (b) the rules by which member's meetings and board meetings were governed;
- (c) the contract conditions applicable to members;
- (d) a minimum code of conduct required of members;
- (e) possible actions that the exchange could take against members who did not comply with the rules;²² and
- (f) a power in the clearing house, or the board of the S.F.E., to take certain actions in the event that an "undesirable situation or practice" in the marketplace arises.²³

3. *Some Problems and Abuses Within the Market*

Before examining some of the more recent regulatory endeavours it would be useful to consider some abuses and problems that have been associated with the commodity futures market. Although in the context of the American system, the following excerpt is of relevance to the Australian Market today:-

The tremendous growth in the market for commodity futures has carried with it, however, increased potential for abuse. Instances of unauthorised trading, churning and similar manipulative practices have begun to appear with greater frequency. The prevalence of such problems raises doubts about the ability of the existing regulatory framework — statutory, administrative and judicial, to preserve the customer confidence necessary to maintain an orderly market for commodities.²⁴

As perceived by the C.A.C. and other bodies, the main sources of abuse within the Australian futures market are:

- (a) The financial stability or otherwise of members and especially associate members;
- (b) the growth in the use of 'managed' or 'discretionary accounts' by the investing public;
- (c) the possibility of manipulation within the market for any commodity;
- (d) the use of options in relation to commodity futures;
- (e) the "suitability" or otherwise of clients; and
- (f) the use of the "tax straddle".

It is instructive to explain each in turn.

21 As well as general by-laws, each commodity has its own set of by-laws which, among other things, set out in the contract specifications.

22 Under Article 4 the board could fine or suspend a member who had "failed to comply with the articles or any by-law or has done any act or thing which has or may operate to the prejudice of the exchange ...". This far reaching power was used once only during 1980-81 according to Stephen Calder of the S.F.E. On that occasion the maximum penalty of \$10,000 was imposed on a member who had defaulted in contract delivery.

23 An example of the exercise of this power can be seen from the instance when the board of the S.F.E. attempting to avert a price squeeze being applied by speculators on the Spot September Cattle Contract, ordered that only "trading for liquidation" be permitted for the remaining week of its life. *Australian Financial Review*, September 15, 1981, 1.

24 R. Hudson, "Customer Protection in the Commodity Futures Market" 58 *Boston Uni. L.R.* (1978) 1.

(a) *Financial Stability Problem*: This problem is of most concern to the C.A.C. The recent failures of such members as Booth Newman (1979) and Ross, McConnel, Kitchen (technical failure — 1980) and the failure of three associate members since July, 1980 have been much publicised. This ties in with one of the main concerns of the S.F.E. that being the “casino” image of “futures” which these crashes promote. Insufficient financial backing and greed seem to be the main reasons for the failures.

The gold crash led to three notable court cases.²⁵ In the major one *AML Finance Corporation V. Wallace*²⁶, the court held that a broker who could not contact his client or whose client refused to pay margins when called, was entitled to close out that client’s contract without his consent, but he was not obliged to do so.

(b) *Abuse of “managed accounts”*: Two separate abuses can arise in the context of managed accounts, viz:

(i) The churning²⁷ of a client’s account; and

(ii) the conflict of interest²⁸ where a broker also trades on his own account.

Churning is of course a breach of the broker’s fiduciary duty to his client. It is very hard to detect in the fast moving commodities market. Even observance of trading levels, turnover rates, trading patterns and broker profits are not conclusive of churning. Consequently, only the most absurd abuse is normally detectable. In the United States, although not yet law, it has been suggested that above a certain threshold turnover rate there be a rebuttable presumption of churning in order to facilitate litigation.

The conflict of interests problem can arise where, for example, a dealer, noting on a given day that all the indicators are pointing to a price rise, decides to buy 20 contracts. He buys 20 contracts, probably all at different prices. There exists the temptation to allocate the best buys to his own account and the others to the managed account(s). When he closes the contracts out there would arise the same temptation to maximise his own profit.

The above problems become even more obvious in the context of the “commodity pool accounts”, a relative newcomer to the market.

(c) *Problems of manipulation*: Manipulation may be “short” or “long”²⁹. In the typical long manipulation the trader acquires a dominant long position and then obtains a large percentage of the deliverable cash commodity. Instead of liquidating, he stands for delivery, and traders with short positions, unable to deliver, must pay artificially high prices to liquidate their positions. The traders with the long contracts are said to “squeeze” or “corner the market”.³⁰ In Australia this is most likely to occur in the wool or cattle markets. In severe situations the S.F.E. has shown its willingness to step in.³¹

25 Two were settled out of court. Both actions were brought by Ross, McConnel, Kitchen & Co. Pty Ltd against associate members Kenneth Simpson and Milne Jurisich.

26 (Unreported) Supreme Court N.S.W. 19 August, 1980.

27 “Churning” is excessive trading by a broker of his client’s account to generate commissions without regard for improvement of the customer’s position.

28 Otherwise known as “dual trading”.

29 A person is said to be “long” of the futures market if he has brought more contracts than he has sold —the opposite applies to “short”.

30 In the United States, Bunker Hunt, his family and friends, lost a reported \$5 billion in an attempt to corner the silver market.

31 Note 23 *supra*.

(d) *Commodity options*: Frauds a few years ago were particularly common in the London options market. Options never really gained any sort of popularity with Australian traders. Prior to its failure, Booth Newman was the only floor member trading options in any significant way.³²

(e) *Suitability of clients*: To satisfy his obligation under the suitability doctrine, a broker must recommend to a customer only those trades that are appropriate in the light of the customer's financial resources, investment objectives and needs.³³ In the United States attempts to apply the securities law applicable have failed since virtually *all* trading in futures is extremely risky. In Australia the issue is not universally acknowledged³⁴ and any suggestion to employ a "fixed nett worth minimum" test on clients is considered amusing.

(f) *The "tax straddle"*: A good example of this device involves taking opposing positions (the straddle), waiting for a price fluctuation in either direction and then taking another straddle position (with the same delivery date) before the end of the tax year of income. Again before the end of the tax year of income a contract of the first straddle is closed out with a contract of the second straddle (the cross) to produce a loss for the year. An offsetting profit lies in the remaining two contracts which is realised by closing them out (the double cross) after the close of the tax year. A deferment of income tax is thus sought.³⁵

The Federal Commissioner for Taxation, conscious of the practice, has declared profits from futures trading as taxable but losses as *prima facie* non-deductable. The onus is on the trader to show that he is in fact a "trader" for the purposes of the tax legislation.

At this moment, hundreds of taxpayers are having their 1980-81 assessments held up because they have claimed losses on commodity trading. As a result it looks inevitable that challenged assessments will go to the courts.

In the United States where the taxation laws are more extensive it was also found that there were no provisions of the Act into which the peculiarities of futures could be slotted. To this end specific legislation dealing with futures was enacted. The Americans now tax futures trading profits at 32¢ in the dollar and losses are allowed. The lack of legislation which has the ability to catch futures in Australia is merely another example of a system of regulation which has failed to keep pace with an area of increasing growth.

32 Although beyond the scope of present discussion it is of interest to note the jurisdictional war waging in the U.S. over who has regulatory control over options and financial futures. The C.F.T.C. claims "exclusive jurisdiction" over all futures markets while the S.E.C. contends that if these things are not securities then they are at least closely related proxies and therefore under its control. *Australian Financial Review*, 25 September, 1981, 66.

33 R. Mundheim, "Professional Responsibilities of Broker-Dealers: The Suitability Doctrine" (1965) *Duke L.J.* 445.

34 On this point the N.C.S.C. has made approaches to both the S.F.E. and the I.C.C.H. expressing concern over "cowboy" associate members in the market who are indiscriminate in the choice of their clients.

35 Dow, Batten, "Commodity Futures Transactions" *The Chartered Accountant in Australia*, June 1980.

4. *Past Control of Abuses*

Controls over and surveillance of the above problem areas have been sparse. Action has in some instances been taken as in the 1981 September Cattle situation³⁶, however, whether or not the action taken so far is a true measure or otherwise of the prevalence of the particular fault in the market, is largely a matter for conjecture.

The S.F.E. is extremely conscious of its public image and anxious to preserve its self-regulatory structure. Members of the exchange argue that real controls exist in the system apart from the business rules and further, that commercial necessity motivates the Clearing House (an independent entity) to keep tight controls over all its members in the form of margin calls and deposits (this ensures the survival of the Clearing House itself).³⁷ Another argument canvassed concerns the need of members to retain a high level of credibility with the public in order to compete for clientele. Despite these "safeguards", it cannot be doubted that the move by the S.F.E. to redraft its regulations, was a pre-emptive one. Pre-emptive of what would result in possibly more drastic measures by the Government (through the C.A.C. and now also the N.C.S.C.), if market regulation was not at least 'seen to be' adapting to changing conditions.³⁸

5. *The New Articles and By-Laws: Implications*

Drafting the new Articles and By-laws of the S.F.E. proved to be a lengthy process. The Commission, using its power under section 4 of the Act, sent back one draft to the S.F.E. with a staggering 70 areas for amendment. The new Articles and By-laws came into effect on 1 February, 1982. Generally, they require stricter financial controls a behavioural standards by those members of the S.F.E. who deal with the public. Major differences are:

- (a) Eligibility for exchange membership is now more difficult;
- (b) the board will now include three (3) non-members of the exchange, ostensibly to allow for greater public scrutiny;
- (c) the minimum financial backings have been set at \$100,000 for floor members and \$50,000 for associate members;
- (d) the calling of deposits and margins from clients is made compulsory. At present only the calling of deposits is compulsory and then only as it applies to floor members calling on clients;
- (e) actions which the S.F.E. can take in lieu of "undesirable situations and practice" have been widened;
- (f) there are new regulations concerning the trading of options;
- (g) members are required to maintain prescribed standards of advertising;
- (h) members are required to maintain appropriate client and accounting records.

36 Note 23 *supra*.

37 This is compared to the American situation where the commercial controls are much less effective, given the fact that most exchanges there do their own clearing. The employees of the I.C.C.H. here are not allowed to trade in the market and there is a strict code of secrecy regarding the business of floor members.

38 Another motivation behind the tightening-up was a desire to break into the traditionally sceptical Melbourne Market. This desire became a reality when the S.F.E. opened its Melbourne office in September 1981.

Quarterly financial returns are to be filed with the exchange;

- (i) a minimum standard form of client agreement will come into use;
- (j) there are stricter controls on the lodging of clients' funds with approved corporations;
- (k) there are new controls on discretionary accounts aimed at the elimination of churning and the necessity for keeping clients informed; and
- (l) a Committee for Inspection and Audit (C.I.A.) has been formed, the functions of which *inter alia* are to: Investigate allegations of breach; carry out random inspections and audits; and to ensure that the quarterly financial backing statements are lodged in time. The C.I.A. reports to the board.

There is also an innovative by-law in the new proposed silver contract. This in effect, sets a limit on the price drop or increase of the spot month contract during the last day of trading. This attempts to partially avert manipulation in the silver market.

Until flaws begin to show themselves no one would doubt that the S.F.E. has done a thorough job in the creation of the new 'tight' regulations. It is hoped that the resulting effect will be a "safer" market for all participants. However, it may be argued that the changes are only cosmetic and structural. In order to answer this argument it is necessary and helpful to examine the American system where external regulation is the order of the day.

III. THE REGULATION OF COMMODITY FUTURES MARKETS IN THE UNITED STATES

1. Introduction

The value of the total number of futures contracts traded in the United States amounts to over \$1 trillion annually. Over fifty commodities are traded on more than twenty exchanges. To control this vast market the United States Congress has taken various initiatives to achieve market regulation.

2. Federal Legislative History

- (i) 1922 Grain Futures Act
- (ii) 1936 Commodities Exchange Act (C.E.A.) resulted from the same kind of public protection concerns that gave rise to the 1933-1934 Acts in the Securities field. The C.E.A. gave powers of regulation to the U.S. Department of Agriculture but only as regards some commodities. Any other commodity trading was self-regulating.
- (iii) 1974 Commodity Futures Trading Commission Act which empowered the Commodity Futures Trading Commission (C.F.T.C.) to enforce the C.E.A. and established the C.F.T.C. as an independent regulatory agency with exclusive jurisdiction and wide ranging controls over all futures markets in the United States.
- (iv) 1978 Futures Trading Act which further amended the C.E.A. and granted the states enforcement power to protect the interests of state residents under the Act.

3. *The Commodity Futures Trading Commission (C.F.T.C.)*

(a) *Introduction:* The C.F.T.C. was supplied with virtually the same arsenal of enforcement weapons available to the Securities Exchange Commission (S.E.C.) but in addition it was supplied with a special “emergency power”, whereby the C.F.T.C. can declare an “emergency”³⁹ in the market and direct a contract market to take whatever action it deems necessary to alleviate the emergency situation. Moreover, the exercise of this power has been held to be judicially non-reviewable.⁴⁰

In effect the C.F.T.C. exercises its regulatory functions in two ways: directly, through its own programmes and activities of regulation; and indirectly through oversight of the commodity exchange’s self regulation (which plays an important role in preventing market abuses and protecting customers).

(b) *Powers:* As well as the emergency power the C.F.T.C. can call on a number of other powers in the exercise of its “exclusive jurisdiction” over the United States’ futures markets. They include *inter alia*:

- (i) A power to initiate change to existing exchange rules on its own authority, after determining that such changes are necessary or appropriate. This power exists over and above the power to disapprove the exchange’s own amendments.
- (ii) A power to discipline or expel members of an exchange if the exchange fails to act on its own.⁴¹
- (iii) A power to promulgate rules requiring anyone associated with the futures industry to meet minimum proficiency standards.
- (iv) The C.E.A. (1936 as amended) itself establishes limits on price fluctuation during any trading day⁴² and on a speculator’s net holdings in any one commodity.⁴³ This rule, enforced by the C.F.T.C., attempts to check manipulation in the market before an emergency situation can arise.
- (v) In relation to the fiduciary relationship between broker and customer, the Act is, to an extent, a codification of the laws of agency.
- (vi) There are controls on dual trading⁴⁴ which include the use of mechanical or electronic procedures for recording the time sequence of trades.
- (vii) There are usually audited controls on the financial standing of exchange members.

39 The width of this power has been criticised. Some examples of emergencies are: intervention by foreign governments, natural disasters and price manipulation.

40 *Chicago Board of Trade v. C.F.T.C.* F.2d 1016 (1979).

41 The New York Mercantile Exchange recently agreed to pay a \$200,000 fine for a charge of “failing to deal adequately with abuses by its exchange members” *Australian Financial Review*, 24 July, 1981, 61.

42 See discussion *infra*.

43 For example in 1977, 7 Bunker Hunt family members were charged with exceeding government limits on the number of soybean futures held. In July, 1981 — the family finally agreed to pay the penalty of \$500,000 and to refrain from soybean speculation for two years.

44 ‘Dual Trading’ is where the broker trades his own account in close time sequence to trades executed for his customers.

As well as the standard forums of enforcement of rules, such as arbitration and private rights of action in the Federal court, there is also available to customers aggrieved by violations of the C.E.A., a Congressionally conceived administrative remedy called "Reparations". Claims are made before a C.F.T.C. administrative law judge.

There are obvious differences between the Australian Regulatory System and the American system. The C.F.T.C. possesses broad supervisory powers over futures markets and plays more of an active role in those markets. Also, the C.F.T.C. has powers to change exchange regulations of its own accord and to discipline members directly. There are no similar powers in Australia.

The United States Government, through the C.F.T.C., has a firmer control over the market. Limits on trading and on price speculation control the operation of the forces of supply and demand to a certain extent.⁴⁵ Also the American legislation is more extensive than its Australian counterpart and attempts to cover the field leaving little to the discretion of any given futures exchange.

IV. THE REGULATORY SYSTEMS OF THE UNITED STATES AND AUSTRALIA: A CRITIQUE

1. Introduction

The proponents of the status quo in Australia have been quick to point out the well canvassed criticisms of the C.F.T.C. and of independent regulatory agencies in general. The C.F.T.C. has been described as a new agency eager to justify its existence.⁴⁶ With an annual budget of around \$16.3 million it might well have to continue in this process of justification. The C.F.T.C. has often been criticised for its unfettered control and is viewed by some as promoting inefficiency. The emergency power has been hotly criticised by economists⁴⁷ and many claim that a premature exercise of this power would be in violation of its statutory grant of authority.⁴⁸ Finally, with thousands of cases pending, the reparations procedure has been called an "Administrative nightmare".⁴⁹ However, no one has argued that the C.F.T.C. is totally ineffectual. Ostensibly, it seems to control the market with a reasonable degree of effectiveness. This poses the second limb of the issue as to whether government regulation is to be preferred to self-regulation.

45 However, the C.F.T.C. would probably argue that it merely controls artificial forces and pressures.

46 Note 24 *Supra*, 9—14.

47 Comment, R. Gray, "When Does Aggressive Trading Become Market Tampering" (1980) 35 *Bus. Law* 745.

48 T. Curtess, "Judicial Review of the C.F.T.C." (1981) *Nebraska Law Review*.

49 Comment, D. Tendick, "Introducing the Regulator: Commodity Futures Trading Commission" (1980) *The Business Lawyer* 751.

2. *Regulatory Agencies: General*

Believers in self regulation encourage the freeing up of the market. Current trends of de-regulation tend to reflect the new-capitalism emerging in many Western and for that matter Eastern bloc communities.⁵⁰ Western society is seen to be basically ambivalent toward the idea of government regulation of economic activity. In the United States, the social consensus that prevailed during the years of the New Deal⁵¹ supporting the enlargement of the role of administrative agencies seems to have waned somewhat. Other concerns which have been expressed relate to the problems of bureaucratisation and public scepticism of administrative expertise.

3. *Conclusion*

Perhaps the ideal solution to the regulatory problem lies in a compromise between government regulation on the one hand and self-regulation on the other. The term most often used to describe this phenomenon is "co-regulation". To be fair, the Australian regulatory system includes at present some elements of co-regulation. Section 5(2) of the Futures Markets Act 1979 (N.S.W.) provides for a watchover situation as regards the disciplining of exchange members. Section 6 enables the C.A.C. to enforce the S.F.E.'s business rules.

Whether or not this element of external surveillance is sufficient, is arguable. There is, for example, no provision whereby the C.A.C. can force the S.F.E. to update redundant or outmoded rules. Exchange members argue that the new Articles and By-laws tighten up to a significant degree, the regulation of the futures market. They also point out the commercial and credibility controls outlined above.⁵²

A weaker, yet possibly adequate compromise would be the creation of an informal committee, made up of Commission officials and Board members of the exchange. A closer monitoring of the market could, as a result, be achieved without constricting the market in any formal way at all. Also a public awareness programme aimed at educating the public in the risks and implications of trading would be beneficial.

4. *Current National Regulatory Proposals*

The Sydney exchange is regulated to some extent by the N.S.W. Act. Outside the state, non-members of the S.F.E. are free from regulation while members are covered by the business rules of the S.F.E. During 1982 the matter was discussed at a Ministerial Council meeting of the National Companies and Securities Commission (N.C.S.C.). As a result national regulation of the futures industry now seems a certainty.

50 In the United States there are signs that the self-regulatory platform has gained support. Government permission has recently been granted to the U.S. Futures Industry to form an industry wide self regulatory organisation much like the National Association of Securities Dealers (N.A.S.D.) in the stock market. *Australian Financial Review*, 25 September, 1981, 67.

51 1956 and following.

52 See earlier discussion of this point.

The proposed regulations will be based on the Securities Industry Codes and will take into account existing S.F.E. requirements. It would appear that this exercise is to be undertaken in a spirit of co-operation with the S.F.E.⁵³ One may wonder where the compromise between the desire of the S.F.E. to keep the industry self-regulatory and the desire of the N.C.S.C. to introduce some degree of accountability will find its resting place.

Among the issues to be considered by the legislators will be:

- (a) a system for licensing all futures brokers in Australia, whether they are members of the S.F.E. or not;
- (b) a code of conduct to be observed by brokers;
- (c) supervision of all futures exchanges in Australia; and
- (d) the establishment of an advisory board to provide policy advice on futures.

A highly contentious matter likely to be resolved by the N.C.S.C. investigation is the question of offshore futures trading in overseas markets and international participation in the local market. The Reserve Bank, for example, will be attempting to attain control over the practice of locating a futures trading profit in another country. Presumably the taxation problems canvassed above will also be considered.

It seems clear that the S.F.E. will steer direct proposed regulatory scheme in a way which provides for the evolution of extra financial futures contracts and other contracts which might otherwise be regarded as illegal⁵⁴ for securities.⁵⁵

V. CONCLUSION

The Sydney Futures Exchange is keen to avoid a regulatory overload. Most members strongly favour the present self-regulatory system. Any co-operation on the part of members with those who regulate can be explained by a desire to improve the public image of futures trading or to effect a growth in the market. Intervention along the lines of the American system is disapproved of by members. External controls on the futures market would restrict the flow of trade and the consequent growth of the market itself.⁵⁶ Only by a continual improvement in self-regulation will exchanges and their members effect a workable balance between industry needs on the one hand, and consumer protection in the Australian Commodity Futures Market on the other.

APPENDIX 1

No one in the futures industry seems entirely certain about the rights and duties of the various parties involved in the formation of a futures contract.

A floor dealer acts as an agent for his client who is an undisclosed principal. However, in practice, the doctrine of the undisclosed principal may not apply, as usually brokers do not intend to enter into contracts on behalf of any particular client.

53 *Australian Financial Review*, 15 July, 1982, 12.

54 Note 18 *Supra*.

55 Note 32 *Supra*.

56 Conversation with Bill Slatyer, Jackson Securities Ltd.

Initially the contract is oral as between floor dealers at the exchange: at this stage the contract is more of a negotiation given that the agreement is subject to clearing house registration. In practice, each dealer records the transaction himself and sends details to the I.C.C.H. for entry into the computer and for registration. The Clearing House guarantees the fulfilment of contracts as between its members⁵⁷ when the transaction is registered.

All futures contracts are made subject to the articles and by laws of the Sydney Futures Exchange Ltd. By law G.1(a) states that "upon registration of each contract with the Clearing House the parties to it each accepts by way of novation such other seller or buyer as the Clearing House may appoint and, upon such event each contract shall be construed as if each other seller or buyer had been the original seller or buyer". In contrast the American approach is that "in technical legal terms a novation takes place... the buyer and seller are no longer in privity with each other... their respective obligations now run directly to and exclusively with the Clearing House".⁵⁸

APPENDIX 2

A simplistic example shows the fault in this construction:

"A" a client tells AB his broker to contract to buy 100 oz of December gold at \$500/oz.

"C" a client tells CB his broker to contract to sell 100 oz of December gold at \$500/oz.

The deal is struck and the contract is duly registered. Therefore the position is initially:

I.C.C.H.

AC.....AB CB.....C

The futures price for December gold rises to \$600/oz. On this happening C has made a paper loss of \$100/oz. This paper loss has been collected from CB by the I.C.C.H. in the form of margin calls.⁵⁹ On the other side, A, who has made a corresponding paper profit, decides to close out his position and realise the profit. So, A's broker AB finds a buyer, DB (D's broker), who agrees on the \$600/oz price. AB registers the deal which in effect frees A from the market. If A, C and D were the only traders in the market then the I.C.C.H. would firstly pay A his \$100/oz profit (\$10,000). Then it would presumably match C's undertaking to sell 100 oz of

57 All S.F.E. members are also members of the I.C.C.H.

58 B.J. Corn and E.R. Schroeder, "Where the Buck Stops: Rights and Duties of the Contract Markets". The (1980) 35 *Business Lawyer* 723.

59 The additional deposits called by the I.C.C.H. if the daily market price moves adversely to the contracted price called "margins". Margins are called on the floor member who in turn makes margin calls on the client. Margins allow the I.C.C.H. to guarantee performance of each and every futures contract and to pay profits to those traders who wish to liquidate their contracts before delivery. The original deposit usually ranges from 5—10% unless the market is volatile.

December gold with D's fresh undertaking to buy the same. But, how can a contract exist for the transfer of a commodity at two differing prices, one at \$500/oz and the other \$600/oz? This is not a problem in the United States where the Clearing House stands as a principal to every contract in the market.

It has been suggested that the first occurring phrase "Seller or Buyer" in By-law G.1(a) should be read as meaning "Seller or Buyer (upon delivery)" and that such a matching is therefore only exercised for practical reasons in the event that delivery is desired. However, if this is what is meant, then the By-law should be made clearer.⁶⁰

⁶⁰ It is likely that the Australian courts will soon have to consider the nature of a futures contract. A tax case, considering whether futures contracts are "trading stock" is imminent.