CLAW 2203

Regulation of Securities Markets

Lecture 4: Securities Trading & Financial Products

Key Terms

Securities
s9: provides 5 different meanings
- Common features: shares in, or debentures of, a body.
- Common exclusions:
  - a derivative, other than an option to acquire by way of transfer
  - a security covered by paragraph (a), (b), (c) or (d); or an excluded security

May include interests in a managed investment scheme.

Debentures
s9: "a chose in action that includes an **undertaking by the body to repay as a debt money deposited with or lent to the body**. The chose in action may (but need not) include a security interest over property of the body to secure repayment of the money."
- Excludes bank deposits

Managed Investment Scheme
s9:
a) a scheme that has the following features:
   - **People contribute money or money's worth to acquire an interest in a scheme;**
   - Any of the contributions are to be **pooled or used in common** to **produce financial benefits** or other benefits for members who hold **interests in the scheme;**
   - Members **do not have day-to-day control** over the operation of the scheme (whether or not they have the right to be consulted or to give directions); o
b) a time-sharing scheme

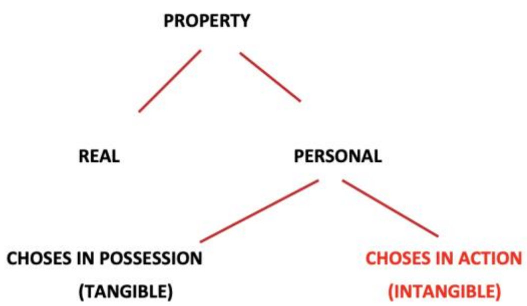
Note: this does not include a partnership or company

Financial Product

S763A
1) For the purposes of this Chapter (Ch. 7) a financial product is a facility through which, or through the acquisition of which, a person does one or more of the following:
   a) makes a financial investment (see section 763B);
   b) manages financial risk (see section 763C);
   c) makes non-cash payments (see section 763D).

This has effect subject to section 763E

Nature of Property



Nature of Interests in Property
Possible to have legal or equitable rights or interests in property (or both).
Example: a share trading trust
- Shares (trust property)
- Trustee has the legal title to the share
- Beneficiaries have equitable title to the shares

Nature of Security Taken Over Property

Mortgage (not used for real property)
Financing can be secured or unsecured.
- If secured, the security can take a variety of forms. One form is a mortgage. At law, a mortgage requires the transfer of title – either legal or equitable.
- A legal mortgage requires the transfer of legal title from the mortgagor (usually the borrower) to the mortgagee (usually the lender).
- Assume the mortgagor owns shares (has legal title) on Day 1 and wants to use the shares as security for a loan from mortgagee. On Day 2 legal title is transferred to Mortgagee as security.

	mortgagor	**mortgagee**
Day 1	LEGAL TITLE to shares	
Day 2		LEGAL TITLE

BUT equity recognises the true nature of this transaction. It is not an outright disposal of the shares, the transfer of legal title was only for the purpose of security.

Accordingly, equity says the mortgagor retains rights to the security (equitable rights) which allow the mortgagor to call for transfer back of the legal title. This right is called the 'equity of redemption' and gives the mortgagor an equitable title.

	mortgagor	**mortgagee**
Day 1	LEGAL TITLE to shares	
Day 2	EQUITABLE TITLE	LEGAL TITLE

Note: Protection for the mortgagor, the mortgagee would have to get rid of the title of equity of redemption in order to sell the shares.

Implications for Trading

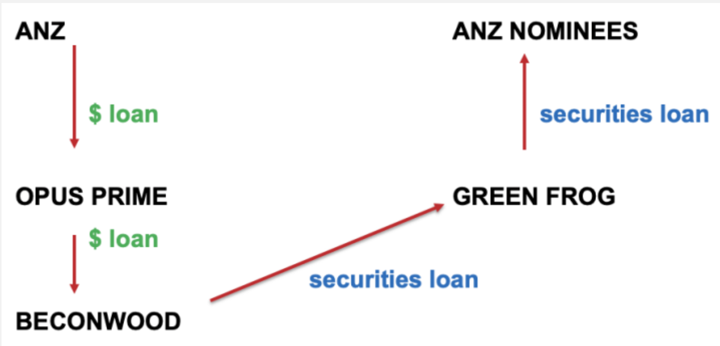
Many transactions involve a concept of 'securities lending'.

What really happens?

Beconwood Securities Pty Ltd v ANZ Banking Group Limited [2008]

Summary

As a security for the loan to opus prime, Beconwood was going to lend shares it had in green frog. ANZ wanted a security for opus prime loan, this ended up being Green Frog shares– When OPIUS PRIME defaulted, ANZ nominees sold Beconwood shares in Greenfrog– but how could they – it was only "lent" them – they had the equity title.



- Beconwood (B) was a client of Opus Prime (OPS), a broker. B wanted a margin lending facility to help it acquire shares.
- As part of the transaction the parties entered into a "Securities Lending and Borrowing Agreement" (SLA) which provided for transfer of the Shares from B to Green Frog (related to OPS). In exchange money was lent by OPS to B.
- ANZ provided the loan funds to OPS and in exchange the Shares were then transferred to ANZ Nominees.
- Following a default by OPS ANZ Nominees began to sell the Shares and B commenced court action to stop the sale.
- Question for Court: did the 'lender' (B) under a SLA have an equity of redemption or other equitable interest in the shares 'lent'? Answer: No.

"<u>The principal objects of securities driven share lending</u> (to enable the borrower to satisfy a short sale or to complete the settlement of a sale within the time) <u>can only be achieved by transferring title to the borrowed securities to the borrower</u>. This is the very essence of the transaction; without the ability to pass title there is no utility in the borrowing." [45]

Thus, was not share lending and was just an outright disposal – not a mortgage – no equity of redemption left – just a contract

Lesson:

Words or titles alone do not make a fact. As Finkelstein, J said:

"What this means is that the character of a transaction is to be determined by reference to its legal nature, not to its economic effect." [42]

Derivatives

What are Derivatives?
s761D (1) defines a derivative as:

An **arrangement (a contract)** under which:

- one party must or may be required to provide at some future time
- **consideration which is based on the value or amount of something else**, including for example an asset, a rate, an index or a commodity.

A derivative is a financial product, but not a security

Purpose of Derivatives:
Originally to manage risk by minimising loss if something happens to the price of the underlying product, especially for commodity derivatives where weather may affect supply and price of product

Who acquires derivatives?
Primary producers; banks; governments; fund managers; speculators; hedge funds

Commodity Derivatives (e.g. wool, wheat, oil)

- Traded on ASX – standard contract under Corporations Act.
- Derivative markets: Commodity derivatives are traded as futures contracts for a particular contract on the ASX by people that own the underlying product and want to manage risk re price fluctuation. The contracting party promises delivery of the commodity at a future time at an agreed price.
- Risk management: crop failure, weather
- Underlying product and the securities exchange
- Shares are traded on ASX in public listed companies that own the product: e.g. oil companies, primary producers.
- Speculators - do not own the underlying product. They buy futures contract at a low price hoping to sell when price moves up

Example: Joe is a farmer whose crop is wheat.

- It costs Joe about $100 to grow 1 container of wheat.
- Joe believes that in 12 months the wheat will not be worth as much as it is today (due to concerns in re the weather).
- Joe wants to reduce his risk (of crop failure) and enters a commodity derivative arrangement by trading under a futures contract with Tim who believes he will make a profit as he has studied long term weather forecasts. Tim promises on the contract to pay Joe $200 a container of wheat.
- Whatever happens to the market price in 12 months, Tim will pay $200. If the price is less than $200 Joe will make a profit. If the price exceeds $200, then Tim will make a profit

Options

Options are traded on ASX and are standard contracts. Under an option one party has the right (not obligation) to buy or sell at some future time at an agreed price.
Examples include:

- **Share** options say over BHP where the price of the option is derived from the price of BHP shares.
- **Currency Options** regarding the price of currencies

Financial Derivatives

Financial derivatives are meant to manage RISK
May be:

1) **Traded on market**, ASX:
   - The contract (standard form) is regulated by ASX, ASIC as a financial product, therefore under Corporations Act
   - Gives protection to the parties
2) **Derivatives Created** and executed off market:
   - Over the counter – OTC
   - Unique to client's instructions
   - Contract is unregulated by ASX or ASIC
   - Remedy for breach is in contract
   - But note OTC's and Part 7.5A Corporations Act

Over the Counter (OTC) – Privately Negotiated Derivatives
Traded outside the market:

- Unique terms according to the needs of the contracting parties but have reporting obligation under Part 7.5A Corporations Act.
- Parties such as banks, governments, brokers want to engage in risk management on a greater scale than is possible for ASX traded derivatives and they write their contract accordingly

Hedge funds trade in OTC's.

An example: Forex Trading (an OTC derivative)

- Investors essentially speculate on whether a currency is going to rise or fall in comparison to another currency — this is called a "pair".
- Brokers link the investor with another party who takes the opposite side of the contract.
- Currently about 70 forex brokers with AFSL – see weeks 5 & 6

Collaterised Debt Obligation

- The underlying product is debt. The financial derivative is a bundle of debts sold to investors.
- If there is a debt default, the holders of the derivatives suffer.
- Some US banks discovered their CDO's included sub-prime debt. There were mass defaults in re this debt.

- In mid-2009 100's local councils, charities, and 600 companies in Australia had what they thought were safe investments when they bought CDO's. These CDO's became worthless when the underlying debts were not repaid – **Wingecarribee Shire Council v Lehman Bros Aust Ltd (in liq) [2012] FCA 1028**

Functions of Derivatives Markets

The functions of derivative markets:

1) **Price Discovery:** A futures market provides a public auction of its contracts and the prices realised represent a market average of expectations about future prices
2) **Risk Management:** ASX Corp Gov Principle 7 – recognise and manage risk
   Risk management products such as derivatives, are in demand when market is volatile and there is uncertainty regarding interest rates, currencies and share prices. **However, the derivative itself poses a risk**

Derivatives and Risk Management

There are four types of risk:

- **Market Risk:** this refers to adverse price movements with changes in market conditions. This risk is manage by:
   a) **arbitrage:** the same good sells for 2 different prices in 2 different markets because availability may affect price. Investor buys low, sells high, this in turn impact on price
   b) **hedging**: taking opposite and equal position in the physical and futures markets – to compensate in 1 market for potential losses in another
   c) **Short selling**: It can be aggressive, massive volumes and create market instability. Hedge funds engage in short selling. 4000+ hedge funds in US and many target Australian market.
      Two types:
      - **Naked Short Selling:** this is where an investor sells a share that he does not own in the hope of buying it back for less. This activity must be declared to the ASX
      - **Covered short:** Here the investor covers the 'sale' by 'borrowing' stock (securities lending). The borrower must notify ASX.
   d) **Margin Calls:** A requirement to provide extra security, or reduce debt, due to fall in value of share prices, or concern re debt
   e) **Speculators:** A speculator takes a future position where there is no risk but they hope to profit from price movements
- **Credit Risk**
   There is a risk that default will occur due to the unenforceability of a derivatives contract as the nature of the contract is based upon forecasts
   - Credit risk is minimal with ASX traded derivatives as the ASX clearing house will intervene.
   - OTC derivatives have greater risk
- **Operation or Management Risk**

The risk that losses will occur because of insufficient internal controls, error or management failure:

- train staff in the derivatives trading division
- monitor trading
- establish systems to monitor risk and ensure trading is in compliance with management policies
- clarify who is able to authorise derivatives transactions

- **Systemic Risk (<u>ASIC's Main Concern)</u>**
  Disruption at a bank, market segment causes widespread difficulties to other companies, or throughout the financial system.

OTC G20 Derivatives Reform Commitments

See ASIC slides on canvas)

1. Reporting now required for ALL OTC derivative transactions
2. All <u>standardised</u> OTC derivatives transactions to be centrally cleared
3. All <u>standardised</u> OTC derivatives transactions to be traded on exchanges or electronic trading platforms, "where appropriate
4. Increased capital requirements, Margining requirements, Bilateral risk mitigation requirements

Corporations Act

Part 7.5A introduced to give effect to G20 agreement.
1. <u>Derivative transactions</u>
s901A ASIC's makes transaction rules –reporting and execution
s901B Minister determines classes of derivatives
s901D exemptions, regulation 7.5A.50,
s901E obligation to comply with rules

2. <u>Derivative repositories (DR)</u>
s902A ASIC supervises DR's
s903A ASIC makes the rules – see s904B
S903A(4) penalty for breach $210,000

3. <u>ASIC Derivative Transaction Rules (Clearing)</u> commenced 2016 to provide for a mandatory central clearing for OTC interest rate derivates in specified currencies.