Submission to the Corporations and Markets Advisory Committee

Insider Trading Proposals Paper

November 2002

1. Introduction

ANZ welcomes the opportunity to provide a submission to the Corporations and Markets Advisory Committee (CAMAC) in response to the *Insider Trading Proposals Paper* released in September 2002, as part of the review of Australia's insider trading laws.

As highlighted in the proposals paper, in March 2002 the Financial Services Reform Act (FSRA) introduced amendments into the Corporations Act, which included "extending the insider trading laws beyond securities (including a limited class of over-the-counter-traded financial products) and some futures contracts to a very broad range of financial products, including all derivatives".[1] The intention of the FSRA amendments was to harmonise the regulation of financial markets and services, so as to minimise both inefficiencies and costs resulting from regulation.

ANZ supports insider trading laws in principle, particularly in their role of ensuring that exchange markets work efficiently and fairly.

However, the capture of over-the-counter (OTC) traded financial products such as credit derivatives under insider trading laws has significant implications for the ability of financial institutions to manage risk. OTC traded financial products such as credit derivatives are one tool used for managing risk, which, while still in their infancy in Australia, are an accepted part of risk management strategy for banking institutions overseas in the United States and United Kingdom.

ANZ has participated in the Australian Financial Markets Association (AFMA) submission to CAMAC as part of the AFMA FSR Task Force and supports AFMA's recommendations to the Committee. Nevertheless, ANZ would like to provide the following comments on the implications of current insider trading laws for OTC traded financial products such as credit derivatives and the limitations this places on risk management strategies.

2. Risk management at ANZ

The identification and effective management of risk is an essential part of banking and a core competency of successful financial institutions. Effective risk management is essential to ensuring the stability of the financial system. ANZ has a comprehensive risk management framework comprising:

- The Board, which approves risk 'appetite' and strategy and monitors progress through the Risk Management Committee;
- The development and maintenance of Group-wide risk management policies, procedures and systems, overseen by an independent central team;

---

[1] CAMAC, *Insider Trading Proposals Paper, September 2002*, paragraph 0.4.

- The use of sophisticated risk tools, applications and processes to execute the global risk management strategy across the ANZ Group; and
- Business unit-level accountability for risk management.

As part of its day-to-day business ANZ needs to manage three broad risk categories:

1. Credit risk – the risk associated with the potential financial loss resulting from the failure of a party to honour fully the terms of a loan contract.

2. Market risk – the risk that the Group will incur losses from changes in interest rates, foreign exchange rates or the prices of equity shares and indices, commodities, debt securities and other financial contracts including derivatives.

3. Operating risk – the risk of direct or indirect loss resulting from inadequate or failed internal processes, people and systems or from external events.

3. Credit derivatives

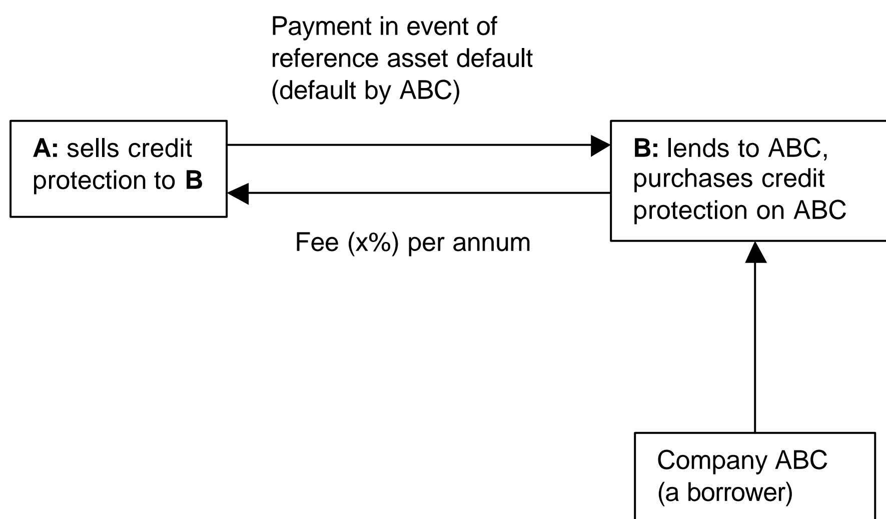
As highlighted in the proposals paper, a key role of OTC markets is to allow the trade in products designed for the transfer of financial, commercial or production risks. Financial institutions use OTC markets to transfer risk through credit derivative contracts such as credit default swaps.

Credit default swaps are instruments designed to transfer the risk of an asset (for example, a loan on a bank's portfolio from the Protection Buyer, that is the lending bank, to the Protection Seller) without transferring the legal ownership of that asset. In Figure 1 the Protection Buyer (B) pays the Protection Seller (A) either a periodic or an up-front fee in exchange for protection against a possible loss suffered if a 'credit event' occurs, such as bankruptcy of the reference entity (company ABC) or the reference entity defaulting on its credit obligation. The protection lasts until the termination date of the protection contract or on the occurrence of a credit event.

The parties to the credit default swap – the protection buyer and the protection seller – are typically highly sophisticated domestic or international financial institutions. While there is no prohibition on less sophisticated parties participating in OTC markets such as these, their participation is highly improbable. Most of these transactions involve credit protection on multi-million dollar assets. The price of the protection is negotiated under contract between the two parties, where the terms and conditions of the contract outline the level of disclosure required.

For a bank such as ANZ, credit derivatives potentially could be used for obtaining or managing exposure on the trading book or managing credit risk on the loan portfolio book.

Figure 1: Credit default swap



4. Is there a need to regulate OTC-traded financial products such as credit derivatives?

Under the current insider trading laws it is possible for financial institutions to use OTC transactions such as credit derivatives to manage the trading book, provided that strict Chinese Wall arrangements are in place where the corporate banking arm of an institution holds price sensitive information about a reference entity. ANZ has well defined Chinese Wall arrangements and protocols in place to ensure that ANZ's trading desks within the Capital Markets and Foreign Exchange Divisions are capable of operating within the current legislation.

In contrast, it is difficult for the corporate bank to use credit derivatives to manage credit risk on a financial institution's loan portfolio under current insider trading laws. ANZ has a Portfolio Management function managing credit risk on ANZ's loan portfolio, which is effectively subject to Chinese Wall arrangements. However these types of arrangements are not optimal in that they act contrary to best practice risk management. Best practice risk management should involve utilising all sources of available information, both publicly available and available through the client relationship, in managing exposures on the banking book. The current legislation requires information that is typically sourced from clients to be withheld from the process of managing loan portfolio risk.

The key rationale for prohibiting insider trading is that regulation is needed to ensure that markets operate efficiently. Insider trading regulation aims to overcome the market inefficiencies which arise from asymmetries in the information held by two parties to a transaction.

In transactions on an exchange such as the ASX insider trading regulation is necessary. Retail participants are essentially price takers and are not in a position to protect themselves from risks arising from information asymmetries through tailoring contractual terms or prices.

As explained above and in the proposals paper, OTC transactions can be tailored through bilateral negotiation. The parties to the transaction are in a position to protect themselves through specifying the level of disclosure in the terms of the contract and through incorporating any risks of information asymmetry into the price. And as further highlighted in the proposals paper these parties can then rely on statutory and common law protections against misrepresentation or false and misleading statements.

The decision to regulate must take into account whether the inefficiencies that arise from the market failure, in this case information asymmetry, are already addressed by the market and if not, whether the benefits of regulating to address the market failure outweigh any regulatory costs borne by the market. In the case of OTC transactions such as credit derivatives, it is clear that the market through the contractual terms and conditions negotiated between the parties addresses any information asymmetries arising in the transaction. Hence, regulation to overcome information asymmetries in OTC transactions is unnecessary and would also impose an unnecessary restriction on financial institutions' ability to use these tools as part of managing their credit risk.

5. Breach of a Chinese Wall

If the insider trading laws remain as they stand, financial institutions are more heavily reliant on the effectiveness of Chinese Wall arrangements to ensure compliance with the current regime. However, the extension of the insider trading regime from securities (as defined pre-FSR amendments) to a substantially greater number of financial products also increases the possibility that a Chinese Wall may be breached inadvertently.

For example, a person possessing inside information may not deal in *relevant Division 3 financial products,* but procure another person to deal, or communicate the information to another person who would be likely to deal or would be likely to procure another person to deal, in the *relevant Division 3 financial products.* In these circumstances, it is an offence to trade in the particular product until the inside information ceases to be inside information. In some cases, this may not occur for some time or may not occur at all.

If a Chinese Wall were breached inadvertently by an organisation trading in financial products such as OTC traded financial products, the organisation has no ability to 'repair' the breach. Instead, at the very least the organisation must not deal in the particular product and possibly not deal in products of that class or type. This could have serious consequences for the risk management practices of the organisation and also for clients of the organisation.

ANZ recognises the sound policy behind ensuring that Chinese Walls are robust. Organisations should have strong incentives to ensure that their Chinese Walls remain intact. However, in cases of an inadvertent breach ANZ proposes there should be a means to 'repair' the Chinese Wall. One option for repair could involve reporting the breach to the market operator in the case of products that can be traded on a financial market or by reporting the breach to ASIC in all other cases. Dealing in that product or products of that class could then occur on the terms set down by the market operator or ASIC.

6. Recommendation

OTC traded financial products such as credit derivatives are an accepted risk management tool for banking institutions around the world. The capture of OTC traded financial products such as credit derivatives under Australian insider trading laws has significant implications for the ability of financial institutions in this country to manage risk.

It is ANZ's view that current insider trading laws as they apply to OTC transactions such as credit derivatives are unnecessarily restrictive. As the law currently stands, financial institutions are not in a position to use these tools for managing credit risk and there does not appear to be a sound economic rationale for this restriction.

Ideally, it would be preferable if insider trading laws as they apply to OTC traded financial products were repealed but we recognise the practical difficulties involved in changing the legislation at this stage. However, as a second best solution ANZ would support the exemption from insider trading laws of OTC transactions where the reference entity is a publicly listed company. In these instances, the reference entity would be subject to the continuous disclosure rules of the ASX and would be publicly rated by a third party rating agency.

If the insider trading laws remain as they stand, ANZ considers that there should be a means to 'repair' a Chinese Wall in the case of inadvertent breach such as reporting the breach by reporting the breach to ASIC for products that cannot be traded on a financial market.