FUTURES TRADING LAW AND REGULATION IN SINGAPORE: AN INTRODUCTION

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"All the days ordained for me were written in your book before one of them came to be." Psalm 139:16

CONTENTS

SUMMARY

This paper seeks to be an introductory text and aims to present an overview of the law and regulation of the futures industry and market in Singapore.

Chapter 1 begins with a general discussion of the Singapore experience in futures trading, highlighted by the Barings crisis. It continues to chart the objectives of futures trading law and regulation and describes the general framework for supervision of the futures market in Singapore.

A discussion of futures trading in Singapore would be incomplete without an indication of how futures came to be traded and how Singapore fits into the global futures explosion. Singapore's existence on the futures scene is connected intimately with the US experience. This is recounted in Chapter 2, together with a general primer on financial futures.

The legal concept of "futures" remains amorphous. For the purposes of the first two Chapters, the meaning of "futures" is limited to exchange-traded forward contracts. However, the definition of a "futures contract" in the Futures Trading Act may possibly include non-exchange traded forward contracts (which in industry parlance are called OTC derivatives). The uncertainty and ambiguity behind certain definitions of basic terms in the Futures Trading Act is explored in Chapter 3. The exploratory discussion does not lose sight of the fact that what is

at issue is the identification of a product for statutory governance and this must depend on the rationale for governance.

SIMEX, Singapore's financial futures exchange, has intricate and complex systems in place for the trading of financial futures, impossible to describe comprehensively herein. However, Chapter 4 provides an exposition of the basic set-up and trading mechanics in sufficient detail to obtain an elementary understanding of an exchange and clearing house system. A necessary description of the MAS as the overall supervisory authority and its powers in relation to SIMEX and market participants starts off the chapter.

Chapter 5 deals with market entry requirements as well as the continuing obligations that market participants owe to the MAS and SIMEX. The chapter also deals with the common issues that arise between licensed members *inter se*. As for the duties and obligations between a member broker and its non-member customer, Chapter 6 examines the duties which arise as a result of the fiduciary relationship inherent in a broker-customer matrix, as well as other duties imposed by futures law and regulation.

It is hoped that this paper would be a helpful compilation of existing futures legislation and regulation, and highlight areas of uncertainty and ambiguity rife for reform or clarification. Nevertheless, an introductory text necessarily leaves out much. For example, the effective regulation of a local market comprised mainly of international players must depend, to an extent, on international co-ordination with other markets. The future for futures market governance lies in the international arena and the Barings crisis has highlighted this for the island republic of Singapore. However, due to limitations of length, this topic is touched upon only very briefly in Chapter 7.

CHAPTER 1

INTRODUCTION

1. The Singapore Experience

> "When written in Chinese the word crisis is composed of two characters. One represents danger and the other represents opportunity"
>
> John F. Kennedy, 12 April 1959 speech

It takes a crisis to provoke thought and action. The Barings debacle did much to stimulate excited introspection about the financial futures market in Singapore, which until then had ostensibly been another Singapore success story, a phenomenon unceasingly applauded and laden with accolade. As its promotional literature does not fail to point out, the Singapore International Monetary Exchange ("SIMEX") had been awarded the title of "International Exchange of the Year"[1] in 1989, 1992 and 1993. No other futures exchange in the world had been accorded such an honour three times. Barings burst the balloon. The explosive scandal propelled Singapore's fledgling financial futures market further into the international limelight. This time, it was not wholly positive and commendatory.

This is nothing to be ashamed of. Crisis after crisis make up the history of financial futures trading. Indeed, the governance of financial markets as a whole is

[1] By the International Financing Review, an UK-based international financial publication.

built upon the legislative and regulatory reactions to one crisis after another. After all, Singapore's present infrastructure for securities laws and regulations were prompted by and installed after the Pan-Electric scandal of 1985.[2] As Joseph B. Dial, Commissioner of the Commodity Futures Trading Commission ("CFTC"), the US agency responsible for regulating the futures industry, opined in the wake of the Barings debacle, the lesson of disaster is not limited to the governance of financial markets: "When it comes to the design of regulatory systems, disaster can teach some powerful lessons. California's building codes are based on that states's experience with earthquakes. Florida's standards owe their structure to hurricanes."[3]

Nicholas William Leeson fled Singapore on the night of 23 February 1995, leaving behind crippling financial losses for Barings.[4] His fearless forays on behalf of Barings into Nikkei 225 Stock Index futures had bust the most blue-blooded of British banks, Barings plc. When Leeson absconded, Barings Futures (Singapore) Pte Ltd ("BFS"), with whom he was employed, had incurred cumulative losses of \$1.4 billion due to Leeson's trading activities. After the collapse of the Barings

[2] It is interesting to note that the prototype legislation designed for securities markets, upon which the legal framework in Singapore and many other jurisdictions is roughly modelled, was introduced in the US soon after the Great Wall Street crash of 1929. For a brief introduction to regulation of the securities industry, see Tan Boon Teik, "Regulation versus Self-Regulation in the Securities Industry," *The Regulation of Financial and Capital Markets*, 1991, Singapore Academy of Law.

[3] In a speech before the Commodities Law Institute and the Financial Services Law Institute on 19 October, 1995 in Chicago, Illinois, USA.

[4] For more information on the collapse of the Barings group, see Board of Banking Supervision, *Report of the Inquiry into the Circumstances of the Collapse of Barings*, 1995, HMSO, London, Michael Lim Choo Sar and Nicky Tan Ng Kuang, *Inspector's Report on Baring Futures (Singapore) Pte Ltd*, 1995, Ministry of Finance, Singapore. For lighter reading, Stephen Fay, *The Collapse of Barings*, 1996, Richard Cohen Books, Nick Leeson with Edward Whitley, *Rogue Trader*, 1996, Little, Brown and Company and Luke Hunt and Karen Heinrich, *Barings Lost*, 1996, Butterworth-Heinemann Asia.

group, the cumulative losses had amounted to \$2.2 billion.[5] The "rogue trader"[6] made the world of financial futures shake, sit up and ask some pertinent questions. How could one man cause so much damage?

The spectacular collapse of Barings touched the souls of regulatory authorities and market participants in jurisdictions all over the world, and caused them to engage in empathic assessment of their own market structures, policies and practices.[7] Preventing the likes of a similar crisis from happening in their own jurisdictions was visibly at the forefront of their soul-searching agenda. It was appreciated that Singapore neither lacked a regulatory structure nor was known for laid back regulatory policies and lax enforcement. On the contrary, Singapore's pride lay in a reliable and credible regulatory environment. The fact that Nick Leeson managed successfully to break the Queen's bank in, of all jurisdictions, Singapore, was startling to many observers.

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[5] See para. 3.54, Ministry of Finance's *Report*.

[6] The phrase "rogue trader" was coined soon after the news broke of Barings' collapse when speculation was rife as to the motivations behind Leeson's activities. In the early days of the scandal, there was conjecture that Leeson had single-handedly ruined the blameless bank, fueled by motives as diverse as greed to anarchic anti-establishment sentiment fostered during his working class youth. The phrase "rogue trader" endeared and Leeson even chose to entitle his tell-all book with it. According to his own account, however, his string of unauthorized trades began with the intention to cover up and recoup some comparatively minor losses due to trading errors which were incurred as early as 1992. Things simply got out of control. There was no greater insidious motive, it was asserted. See Chapters 3, 4 and 5, Leeson and Whitley, *Rogue Trader*. Whatever spurred Leeson's actions, the investigations into the affair have revealed that his speculative forays gone awry could and should have been detected and curbed by a responsible management. Due to a stunning failure of managerial control within Barings, opportunities were created whereby Leeson could engage undetected in unauthorized trading. See the Board of Banking Supervision's *Report* and the Ministry of Finance's *Report*.

[7] For an account of how the Barings debacle would *not* have occurred on an US futures exchange, see Sheila C. Bair, "Remarks: Lessons from the Barings Collapse", *Fordham Law Review*, Vol. 64, 1995 at 1.

2. Objectives of Market Governance

Market governance has as much to do with the prevention of crises as the containment of crises. On the one hand, the fact that the Barings episode did not escalate into a major market disruption seems to suggest that tribute is due to the present regulatory structure insofar as the systems in place for damage control seemed to have worked. On the other hand, the fact that the damage occurred has caused many to question whether a stricter regulatory scheme could have prevented the unfortunate episode, and if so, at what cost. The reality appears to be that the exchange rules existent at the time would have prevented the unfortunate episode, had they been adhered to.

Although the Barings collapse has been attributed largely to Barings' internal management's inadequacies and failures, it also highlights the inherent limitations of financial markets governance. Copious legislation and regulation can only be as effective as the corresponding surveillance and enforcement. In particular, on the exchange level, the exchange rules are only as effective as the exchange's surveillance and enforcement of the same, which should be an intense and purposeful vigilance. This layer of industry or exchange self-regulation, however, is necessarily contaminated with commercial self-interest. An exchange, at the end of the day, is a business proposition. The Barings episode illustrated well the blinding effects of commercial self-interest and unbridled enterprise on an exchange's regulatory reflex.

The exchange rules in force at the time on position limits[8] would have hampered Barings taking on the number of open positions that they did. However, position limits were increased for Barings as stated in the Ministry of Finance's *Report*:

> "Under SIMEX Rules, no client may hold a position in excess of 1,000 outstanding Nikkei futures except with SIMEX's approval. BFS had apparently been granted an extended limit of 10,000 Nikkei futures for [Baring Securities Limited]'s trading. This limit was to cover trading in both futures and options." [9]

The tenfold increase of position limits by SIMEX appears to have been done without the approval of the Monetary Authority of Singapore ("MAS") whose approval was required under the appropriate regulations.[10] To exacerbate matters, these increased position limits were further relaxed by SIMEX when they had been exceeded:

> "Based on the positions reported to SIMEX, it appeared that BFS had exceeded its approved limit on a few occasions. However, SIMEX relied on the fact that the margins were being met in full, and did not raise the matter with BFS."[11]

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[8] Position limits are discussed further in the section "SIMEX as Clearing House" at Chapter 4.
[9] Para. 15.31, Ministry of Finance's *Report*.
[10] Reg. 16 of the Futures Trading Regulation in force at the time stated that the position limits for futures contracts listed on SIMEX "shall be the quantity determined by the Exchange and approved by the Authority." However, Rule 1502:F of the SIMEX Rules stated that the Board "may from time to time provide exemptions to the...position limits." Reg. 16 has subsequently been amended after the Barings episode to provide that the position limits "shall be determined from time to time by the Exchange based on such criteria or methodology as may be established by the Exchange with the approval of the Authority." On the face of it, this appears to be a relaxation of the previous provision and gives the MAS a more detached role. This is surprising since the change was part of a wave of post-Barings amendments.
[11] Para. 15.32, Ministry of Finance's *Report*.

SIMEX's reactions were not the preferred reflexes of a regulatory body free of self-interest. The inescapable reality is that SIMEX is a commercial entity. As the legislators and the MAS have to consider the consequences of their policies on the competitiveness of Singapore in a global context, SIMEX officials have to consider the consequences of their regulatory actions on the exchange's competitiveness and very survival in the global futures jungle. As the Inspectors pointed out in their *Report*:

> "In its efforts to promote the growth of the futures market in Singapore in the context of a highly competitive international environment where other markets have less stringent rules on segregation of customer funds and trading practices, SIMEX may have been overly liberal in granting increases in position limits. It may not have been sufficiently sensitive to the risks associated with the very large volume of business transacted by BFS"[12]

Rules on position limits, large position reporting, margin levels, financial and other administrative and accounting requirements for market participants aim to protect the market by ensuring that market participants do not overstretch themselves and that they conduct themselves in an orderly and predictable manner, such that any deviation from a routine and established market presence would alert regulatory authorities to a potential problem. In the fast-paced environment of futures trading, to be effective, regulators must be prepared to react and take decisive action at the slightest hint of unusual market activity. The lack of timely

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[12] Para. 15.42, *ibid.*

regulatory intervention at the exchange level could lead to disastrous consequences as the *Report* bemoaned:

> "...this incident highlights the risk of relying on the integrity of supposedly venerable financial institutions. When SIMEX began noticing irregularities in BFS's operations, SIMEX sought and waited for an explanation. With hindsight, SIMEX should have promptly conducted a full and thorough investigative audit of BFS and informed both MAS and [Baring Securities Ltd]'s regulator, the [Securities and Futures Authority], of its concerns, instead of waiting for explanations...That is a matter of judgment. However, this episode reflects the need for speedier enforcement action by SIMEX, instead of relying an an institution's reputation or on foreign regulatory authorities supervising the activities of the head office of such institutions." [13]

Although an overriding layer of statutory control is imposed on SIMEX, and a governmental authority free of self-interest, namely the MAS, is appointed to oversee the exchange's activities, surveillance of day-to-day activities is necessarily done by the exchange itself. To impose a system of checks independent of the exchange is an unrealistic and costly option in the complex, fast-paced and high-tech environment of financial futures trading. The present system relies heavily on the integrity of the exchange in performing its self-regulatory role.

The specific conflict of interests encountered by exchange regulators in making the choice between the promotion of growth or the protection of the market at the expense of growth is but a mere reflection of the dilemma of market

[13] Para. 15.44, *ibid.*

governance on the whole. At one end of the spectrum is the adoption and enforcement of burdensome and comprehensive market safeguards, and at the other end, is the encouragement of a competitive and active market through *laissez faire* policies. The tightrope that the governors of markets tread is treacherous.

Singapore's bid to become or retain its status as a world class financial centre or, at the very least, one of the more formidable financial centres of Asia is boosted by the presence of a financial futures market. "Overregulating" this market would be unwise. Overregulating would comprise high capital adequacy standards as entry requirements for market participants, high margin deposit levels or onerous reporting or disclosure requirements for positions undertaken. Naturally, what is considered high or onerous is relative and depends on the requirements adopted by competing futures markets. Overregulating leads to higher regulatory compliance costs for market participants, and in a competitive global market, a jurisdiction which sacrifices the competitive edge for expensive regulatory security would have diminishing trading volumes to show for it. Singapore's loss would be Chicago's, London's or Osaka's gain. On the other hand, "underregulating" a financial market would expose the market to weak market participants, unscrupulous practices or unabated and precipitous speculation, leaving it prone to crises, thereby undermining international investor confidence in the market. This has as much of a negative effect on the futures industry as does overregulating. There is no choice but to walk the tightrope and the authorities have to constantly monitor the dizzying drop on either side.

It is indisputable that futures trading is an activity which requires legislative and regulatory oversight to prevent fraud, malpractices, market manipulation and excessive speculation. The history of various futures markets has proved the point. The failure of many unregulated futures exchanges[14] has shown that legislation and regulation are required to protect the futures industry and its participants from themselves. Trading or broking futures can be a lucrative endeavour and since the first century, the warning has been rung: "People who want to get rich fall into temptation and a trap and into many foolish and harmful desires that plunge men into ruin and destruction."[15] A timeless truth for the new millenium.

At the lowest level, market governance efforts are directed towards the protection of the investor from the unscrupulous salesman, hungry for profits and commissions. Shoddy service, hard sells, false promises and outright scams where deposits are collected and misused were common complaints against brokers lacking in integrity. The smell of easy lucre may tempt some to "proffer" futures contracts for a quick buck in a less than morally defensible manner. Legislation has stipulated licensing requirements for brokers or those involved in dealing with futures to ensure their professionalism, financial stability, moral accountability and the prudent administration of their affairs.[16] Further, there are strict requirements

[14] For example, the failure of the Gold Exchange of Singapore ("GES"), the predecessor of SIMEX, was precipitated by government investigation into a series of frauds and cheating scandals. There were instances of unscrupulous brokers absconding with customers' monies or trading without their customers' instructions. There had been no legislation or regulation tailor made for the GES and investigations had to be commenced under the company and criminal legislation in force at the time. For more information on the GES and its collapse, see Chapter 2, Robert K.G. Chia and Doreen Soh, *SIMEX and the Globalisation of Financial Futures*, 1986, Times Books International. See also "History in Brief" at Chapter 2 below.
[15] 1 Timothy 6:9-10, New International Version.
[16] For a detailed exposition on licensing requirements for futures market participants, see "Market Entry Requirements" at Chapter 5 below.

for customers' funds to be segregated,[17] to ensure that they are not improperly dealt with, and there are rules requiring those broking futures to disclose the risks involved to their customers, to discourage and prevent misrepresentations and puffs.[18]

The protection of the "consumer" investor, however, does not appear to be the prime nor the sole objective of futures market governance in the Singapore context. Dr Richard Hu Tsu Tau, the Minister of Finance, acknowledged at the Second Reading of the Futures Trading Bill, which consequently was passed as the Futures Trading Act, in 1986, that:

> "...the players in this market are generally professionals, people who I think are well aware of the risks involved and I take the point that the public at large should be cautioned again and again that this is not a casino they should indulge themselves in. Fortunately, the complexities of the market are such that I doubt very much that many non-professionals would indulge in it."[19]

The financial futures market in Singapore has a large presence of institutional investors, for instance, fund management or banking institutions, insurance companies and trading companies or conglomerates. These corporations are the antithesis of the stereotypical "consumer" who is either devoid of specialist knowledge of his purchase or one who contracts on an unequal bargaining level with the seller of the product. Nevertheless, certain provisions in the legislation

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[17] See "Segregation of Customer Monies" at Chapter 6 below.
[18] See "Risk Disclosure Statement" at Chapter 6 below.
[19] See Singapore Parliamentary Debates, vol. 47 at col. 1439 (31 March 1986).

like the requirement of risk disclosure statements are evidently targetted at the "consumer" investor. Other provisions which deal with the segregation of customers' monies and licensing requirements work to protect institutional investors as much as "consumer" investors. Even the "big boys" would benefit from being protected from shoddy service and unscrupulous conduct on the part of those with whom they entrust to execute their hefty orders and with whom they deposit hefty margins.

The protection of individual investors is but a method towards the promotion of a futures economy and market ready for play in the international arena, which one supposes, benefits the greater societal whole. It is this wider objective that appears to overpower. Dr Hu at the Second Reading of the Futures Trading Bill stated that:

> "...the Futures Trading Bill is proposed to ensure that our futures market is operated properly and that public interest is preserved. Furthermore, the Bill will provide international investors with the confidence that our futures market is operated fairly."[20]

The idiosyncracies of the Singapore economy are mirrored in its financial futures market. SIMEX does not trade any indigenous or original products. SIMEX promotes itself as a supermarket carrying on its shelves internationally recognised quality products. The imported products are value-added with SIMEX's market infrastructure, systems and controls. It is inevitable that the

[20] See *ibid* at col. 1433.

major thrust of futures market governance would appear to be the maintenance of a free yet stable, credible, reliable and efficient market. Certainly, the investor, either a retail consumer or an institutional one, and his investment will be protected by such an approach, but the emphasis is not on the individual and the protection of the individual is a necessary means to an end. Whether the end is nobler than the means or *vice versa* remains interesting food for thought.

3. The Market Governance Framework

The legislative and regulatory framework of the futures market in Singapore is based on the Futures Trading Act ("FTA")[21] and the subsidiary legislation passed thereunder, the Futures Trading Regulations ("FTR").[22] The governmental authority responsible for overseeing the futures industry is the MAS. The FTA and FTR constitute the bare skeletal structure of futures market governance, stipulating criminal penalties for various contraventions of their provisions. At the exchange level, the business rules of SIMEX (the "Rules"),[23] the circulars issued by SIMEX to its members and, to a certain extent, market practices adopted on SIMEX, constitute the regime of industry self-governance. At present, the only futures exchange established under the FTA is SIMEX. Thus, the policy adopted in Singapore for the governance of the financial futures market

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[21] Cap. 116, 1985 Rev. Ed., Statutes of Singapore, as amended by the Futures Trading (Amendment) Act 1995 on 16 March 1995.
[22] 1990 Ed., as amended by GN S 412/94, GN S 6/95, GN S 81/96, GN S 103/96 (revoked by GN S 351/96) and GN S 352/96.
[23] This paper refers to the fourth authorized copy edition, 1995.

is one that combines self-regulation on the SIMEX level with statutory regulation and governmental supervision by an external body, the MAS.[24]

It is imperative to note, however, that the laws, regulations and rules promulgated specifically for the futures industry do not solely govern the futures industry in Singapore. Due to the colonial legal heritage of Singapore, there is a body of common law and equitable principles which are superimposed and impact on the relationships between participants in the futures market. One often asked question is whether such common law and equitable principles attach greater duties to market participants than the mere adherence to the relevant legislation and regulations made thereunder. The futures market's licensed participants, one would believe, are cautious of keeping their activities and dealings with customers within the boundaries of the duties and obligations imposed upon them by the specific futures laws, regulations and rules. It is not difficult to imagine a certain unease amongst such participants when informed of an added burden of amorphous common law and equitable duties and obligations. For instance, a futures broker could conceivably comply with all requirements under the FTA, FTR and the Rules and various SIMEX circulars, and yet encounter assertions by customers that the broker had failed to comply with or had breached certain common law or equitable duties and obligations. Such allegations may have onerous consequences on the broker if they are capable of constituting effective defences to the broker's otherwise valid claims against the customer for amounts outstanding.[25] This is

[24] This is the preferred regulatory policy, seen in, for instance, the US, the UK, Hong Kong and Australia.
[25] The relationship of futures brokers to their customers is discussed further in Chapter 6 below.

based on the conjecture that such challenges are worth taking by a customer who has suffered heavy trading losses and is keen to avoid any liabilities.

Furthermore, licensed futures market participants and many of their customers are structured as companies and the companies legislation in Singapore is evidently imposed on such entities. On the whole, this state of affairs requires little discussion save that in the area of corporate insolvency, Singapore legislation contains provisions[26] that might be at variance with certain market practices of the futures industry, in particular, those practices relating to the automatic liquidation of a defaulter's open positions and the subsequent netting procedures.

The practices of the futures market are designed such that a defaulting party would be swiftly dealt with and any of its vulnerable open positions realized. Any challenges the defaulting participant might take to such swooping action could jeopardize the market. Due to the nature of futures trading, any losses that would launch a participant into insolvency would *a fortiori* be rather large. If the losses of the defaulting party are not dealt with swiftly, with the objective of protecting the futures exchange, the clearing house and others who have dealt with the

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[26] For example, s. 300 and s. 259 of the Companies Act, Cap. 50, Statutes of Singapore ("Companies Act") could conceivably be at variance with the way the contracts of defaulting or insolvent members are "closed out." S. 300 of the Companies Act sets out the requirement that the assets of an insolvent company be distributed *pari passu* amongst all creditors. The *pari passu* principle was further expounded in *British Eagle International Air Lines Ltd v. Compagnie National Air France* [1975] 2 All ER 390 and *Joo Yee Construction Pte Ltd v. Diethelm Industries Pte Ltd* [1990] 2 MLJ 66. S. 259 of the Companies Act prevents any disposition of property made after a winding up has commenced. Furthermore, when a member in a troubled financial state provides additional margin for trading, this might be impugned under s. 329 of the Companies Act which prevents "undue preferences." The UK has already effected changes to its statutory insolvency regime to deal with the perceived problems. For an account of the changes to the relevant UK legislation and a commentary thereon, see Lynn Johansen, Chapter 3, "Futures Trading and Insolvency Law" in Helen Parry, Eric C. Bettelheim and Professor William Rees, eds, *Futures Trading Law and Regulation*, 1st edition, Longmans, 1993.

defaulter, one default might lead to another and place the entire futures market at risk. In lieu of the present uncertain and disconnected state of Singapore insolvency legislation and futures market practice, it is noteworthy but perhaps unsurprising that no challenges were made by the liquidator during the Barings episode. Yet, it would be unwise to leave the law in such an unsatisfactory state on the presumption that liquidators do not in most circumstances wish to fire the cannons of a sinking ship.

Due to limitations of length, the legal issues pertaining to the insolvency of a futures market participant will not be explored. Similarly, other areas such as futures fraud, abusive practices and market manipulation, which contain some overlap with the criminal law, will be left for another expedition.

CHAPTER 2

THE FINANCIAL FUTURES MARKET

1. Financial Futures Primer

The term "financial futures" is not a phrase of art or precision, much less legally defined. On the other hand, the phrases "futures contract" and "futures market" are defined in certain language by the legislature in the FTA.[1] Essentially, the effect of such definitions is to delineate the futures trading activity sought to be regulated within the jurisdiction. To put it somewhat cryptically, "what falls within the FTA is within the FTA and falls without is without." That is to say, only the trading of futures contracts on futures markets as legally defined is caught within the regulatory embrace in Singapore. The trading of futures contracts which fall outside the definitions provided by legislature, remain unregulated.

Leaving aside precise legal definitions, "financial futures" may be roughly defined as futures contracts based on a financial instrument, which may be a currency, an interest rate instrument or a share index. The term "futures contract" in industry parlance is loosely given to a forward contract which is traded on an exchange. A forward contract is an agreement to buy or sell at a date in futurity a specified quantity of a particular commodity. The price is determined at the time of the agreement although performance would not occur until a specified future

[1] See "Futures Market" and "Futures Contract" at Chapter 3 below.

time. The commodities in question could be physical items such as metals, soft commodities such as agricultural products or oil, or they could be financial instruments. Where the underlying commodity of exchange-traded forward contracts is a financial instrument, the commonplace industry description of such contracts is "financial futures".[2]

The concept of a forward contract is not unfamiliar to contract lawyers. A forward contract is merely an agreement to buy something in the future for a price agreed now or at the time of agreement. However, the additional and distinctive feature of a futures contract, not found in the basic forward contract, is the standardization of terms across contracts. This means that futures contracts pertaining to a particular commodity have the same standard terms as to quality, quantity and delivery or settlement dates. This allows the futures contract itself to be traded on an organized futures exchange. A contractual model is usually provided by the exchange upon which such contracts are traded. In brief, the terms of futures contracts are standardized save as to price and the parties involved. Trading on an organized futures exchange provides a forum whereby agreement as to price is obtained between two parties. Futures contracts are therefore characterized by an element of fungibility and liquidity which is lacking in the basic forward contract.

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[2] Where the underlying commodity of a futures contract is a physical item, such futures are oftentimes referred to as "commodity futures". These comprise "metallurgical futures" and "agricultural futures".

It is important to understand that the product which is bought and sold on a futures exchange is not the underlying commodity upon which the futures contract is based, but rather, the futures contract itself. What is bought or sold on the exchange is the contractual right to buy or sell the underlying commodity, at the price agreed on the exchange, at a future date, being a specified time stipulated for delivery or maturity. Therefore, whether a futures contract is profitable or not would ultimately depend on the price of the underlying commodity in the future, for example, on its delivery date. If the cash market price on the delivery date is lower than the price stipulated in the futures contract, the seller of the futures contract would seek to sell to the buyer at the futures contract price, and theoretically is able to buy the underlying commodity at a lower price in the cash market. The buyer of the futures contract is then left with paying a higher price for the underlying commodity than the cash market price, whereas the seller of the futures contract has made a profit from the age old adage of "buy low, sell high". On the other hand, if the cash market price for the commodity on the delivery date is higher than the price stipulated in the futures contract, the buyer of the futures contract would be able to buy the commodity from the seller at the price stipulated in the futures contract. He is then theoretically able to sell the commodity at a higher price in the cash market and make a profit. The seller, unfortunately, makes a loss by selling at a lower price than the cash market price.

Having used the delivery date as an example of a date in futurity, it is to be stressed that oftentimes, delivery of the underlying commodity does not occur. This is because most traders of futures contracts do not participate in the underlying cash market, and opt to "offset" their futures contracts at a date prior to the delivery date. "Offsetting"[3] or "reversing trade" occurs when the buyer of a futures contract or a seller of a futures contract, sells or buys respectively, exactly the same contract at a later date. Instead of the cash market price used to calculate profits and losses as illustrated in the example above, the benchmark price is the futures contract price as listed on the futures exchange at the time of offsetting. The difference between the two futures prices would reflect the profit or loss to either party.

In the case of financial futures where delivery of the underlying financial instrument may be impossible or impracticable to effect, futures exchanges may necessarily stipulate that such contracts are to be cash-settled only on the date of maturity or expiry. This is particularly so in the case of stock index futures and interest rate futures.[4] Therefore, even where a futures contract is held to maturity or expiry, no physical delivery of the underlying financial instrument is required. However, in any case, few futures contracts are actually closed through cash settlement on maturity, as they are often offset at a much earlier stage.

The futures price is based on all information available which relates to the price of the underlying commodity on the future delivery or maturity date. Whilst financial analysts have futures prices valuation models to calculate theoretical futures prices based on available cash market prices, the actual futures price

[3] The offset by liquidation procedure is discussed in "SIMEX as Clearing House" at Chapter 4 below.

[4] On SIMEX, all stock index futures and interest rate futures, as well as gold futures, are to be cash settled only. However, the contract specifications for oil futures and foreign exchange futures provide for physical delivery.

available on exchanges is often difficult to determine accurately because of the indefinite number of factors which influence the markets and investor sentiment. On the other hand, futures prices quoted on exchanges are a useful gauge to determine future cash market prices. This economic function of financial futures is known as price discovery and dissemination.[5]

As a rule of thumb, futures prices converge with the cash market price as the delivery or maturity date of the futures contract draws near. This concept is explained as follows:

> "The price difference between the financial futures contract and the underlying security is known as the basis. When the expiration date of a contract is far in the future, the basis is likely to be quite wide and volatile, as there is likely to be much difference of opinion over the fair futures contract price and the comparable forward market rate. As the delivery date approaches, both the opportunity to deliver and the increasingly accurate expectations of future cash price cause the basis to narrow, until on delivery date the prices converge."[6]

2. Organized Exchanges

Financial futures trading conjures up the image of a boisterous market floor, with individuals tensely cradling handsets, flashing incomprehensible hand signals and yelling equally incomprehensible instructions. These are the characteristics of an active open outcry exchange. At first blush, an open outcry

[5] See "Economic Functions of Futures" below.
[6] See Chapter 4, Barbara L. Carroll, *Financial Futures Trading*, 1989, Butterworths at 63.

market floor seems indispensable as a centre for buyers and sellers of futures to congregate and trade, and where due to the trading activity prices may be constantly quoted to be abided by all who intend to sell or buy standardized futures in that marketplace. The existence of a physical marketplace contributes to the liquidity of a futures contract.

The development from a mere physical marketplace to an organized exchange, however, sprouted from the desire of market participants to eliminate counterparty risk when trading in futures contracts. Counterparty risk is eliminated by the clearing house and margining systems typical to a financial futures exchange.[7] The clearing house clears trades made on the exchange and takes on the responsibility of paying the seller and collecting payment from the buyer of the relevant futures contract. This way, those who trade on the exchange are not hampered by having to make credit checks on counterparties or taking on counterparty credit risk. The clearing house is, in essence, the creditworthy counterparty to all who trade on the exchange.

In brief, SIMEX is both the exchange and the clearing house and is constituted by clearing members, who are essentially the large brokerage institutions. The clearing members are the only ones entitled to submit trades for clearing. Collectively, as the clearing house, they take responsibility for the trades submitted by them individually as clearing members. The clearing house, however, does not take each clearing member's creditworthiness for granted. To protect

[7] For a discussion on the mechanics of the clearing house and margining system of SIMEX, see "SIMEX as Clearing House" at Chapter 4 below.

itself, the clearing house collects margin, being in theory an amount large enough to cover the clearing house for any losses a clearing member could sustain from its trading activities and should such member default from making due payment to the clearing house to cover such losses.[8] A margining system is a typical and necessary feature of an organized futures exchange.

The traditional futures exchange is one upon which trades are made by a system of open outcry. SIMEX is such an example. Trading for specific contracts are done in a designated trading area called a pit. The exchange rules would stipulate that trading may take place only during official trading hours in the pit.[9] In the pit, traders would make offers to buy or sell to other traders. A system of hand signals are used to express wishes to buy or sell, known as "bids" and "offers". On SIMEX, the Rules provide that a hand be outstretched with the palm towards the bidder when making a bid, and a hand outstretched with the palm away from the offeror when making an offer. There is also a highly stylized system of unofficial hand signals to signify quantities and bid and offer prices. However, according to the Rules, when a trader desires to buy the going offer in the pit, he must literally cry out "buy" and likewise, the trader who desires to sell at the going bid must literally cry out "sell".[10] The open outcry system is said to encourage liquidity through its transparency and the participation of "locals". The SIMEX

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[8] For instance, the Ministry of Finance's *Report* at para. 15.48 stated that "SIMEX held adequate margins and was able to liquidate all of BFS's positions and refund a surplus of US$86 million to BFS."
[9] In the case of SIMEX, see Rule 512.
[10] See Rule 512.

local" is generally a trader who trades on his own account for speculative purposes as a form of self-employment.[11]

The open outcry system is by no means the only method of trading available to a futures exchange. Some newer exchanges in Europe have favoured an entirely computerized trading method.[12] In London, the London International Financial Futures Exchange ("LIFFE") launched an Automatic Pit Trading ("APT") system in late 1989 and uses this system to extend futures trading, but exclusively for the Japanese Government Bond ("JGB") contract. Following suit, in March 1996, SIMEX began using a system of computerized trading to extend futures trading for certain contracts. At present, after normal open outcry trading hours, several designated contracts are traded using the Automated Trading System ("ATS") on SIMEX until 1:00am.[13] Orders are executed via ATS terminals which may be subscribed from SIMEX. Incorporated into the ATS is an ordering matching system which adheres to a strict price and time priority for all orders entered into the system. The original FTA's definition of a "futures market" was unclear as to whether such an electronic marketplace was considered a "futures market". The 1995 amendments to the FTA has clarified matters by extending the definition of a "futures market" to include "an electronic system, whether operating in Singapore or elsewhere, through which trading in futures contracts is carried out."[14] The

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[11] See "The SIMEX "Local"" at Chapter 5 below.

[12] The Deutsche Terminborse ("DTB") and the Swedish Options and Financial Futures Exchange ("SOFFEX") are two examples. See Chapter 1, M. Desmond Fitzgerald, *Financial Futures*, 2nd ed., 1993, Euromoney Books.

[13] The contracts are Deferred Spot US$/Y, Deferred Spot US$/DM, Euromark, Euroyen, JGB and Gold.

[14] See s. 2, FTA. The definition continues to exclude "an electronic facility which merely provides price or other information on futures contracts...and which does not permit users of the facility to channel orders for, execute transactions in, or make a market in, futures contracts".

FTA, as amended, stipulates that the approval of MAS is required before SIMEX may operate any electronic facility for trading.[15]

3. History In Brief

The history of trading futures contracts based on an open outcry marketplace and a clearing house system in the US could be traced to the mid-19th century and the midwestern city of Chicago.[16] The Chicago Mercantile Exchange ("CME") specialized in dairy and meat produce whilst its rival exchange, the Chicago Board of Trade ("CBOT") specialized in grain. In recent years, Chicago has enjoyed the acclaim of being the largest centre of futures trading in the world.

The trading of financial futures, however, did not begin until 1972 when the world's first financial futures were traded on the International Monetary Market ("IMM") division of the CME. It was only in the 1970s that the need for financial futures amongst financial market participants emerged. It is not coincidental that the trading of financial futures in the US debuted in the 1970s consequent upon the breakdown of the Bretton Woods Agreement in 1971. The Bretton Woods Agreement had maintained international monetary order since 1944 by fixing currency exchange rates. The breakdown of the Agreement led to the devaluation of the US dollar and the realignment of currency values, which heralded in an era

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The exclusion contemplates electronic price dissemination systems like those provided by Reuters, Telerate, Quick and Knight Ridder, all of whom carry SIMEX futures prices.

[15] See s. 4A, FTA.

[16] For a brief history of futures trading in the US, see generally Chapter 1, Carroll, *Financial Futures Trading* and Chapter 1, Chia and Soh, *SIMEX and the Globalisation of Financial Futures.*

of unprecedented volatility in foreign exchange rates. With the weak and constantly flailing US dollar and rising oil prices due to the oil crisis, the 1970s encountered rampant inflation and the phenomenon of interest rate volatility, as interest rate restrictions and regulations which had existed in the United States since the end of the Second World War were relaxed, in response to rising inflation.

As foreign exchange and interest rates rose and fell, it was realized that they had assumed the supply and demand characteristics of other non-financial commodities, quite like eggs, butter, pork bellies, wheat and soya beans, to name but a few delectable ones. In 1972, the IMM began trading seven kinds of foreign currency futures contracts, on the same principles and practices as futures contracts had been traded on the CME. The open outcry mechanics, clearing house logistics and regulatory regime in place for the trading of futures in commodities were simply adapted to cater for the trading of futures in financial instruments. The increased financial risks of holding currency or cash could not be ignored and a mechanism for hedging such increased risks was seen in futures contracts based on the underlying financial instruments like currencies and interest rates. Price volatility of the underlying commodity is a prerequisite for a successful futures market. Without price fluctuations, there would be no need for hedging to manage risk, and without hedging, there would be no futures market.[17]

[17] There have been occasions on which futures markets have suffered because prices were artificially stabilized. For example, in the 1960s the US government bought large amounts of cotton in order to raise the price. Because the government's purchase price was stable, cotton futures trading in New York dwindled. When government intervention was removed in the early 1970s, a booming market was re-established in New York. This example was cited in Chapter IV, "Necessary Conditions for Futures and Options Markets To Develop", *Futures and Options Trading in Commodities Markets*, 1996, ICC Publishing SA

The establishment of SIMEX came about largely when the CME saw in Singapore an opportunity to forge a linkage with a futures exchange in the eastern time zone.[18] In the 1980's, the CME had apparently viewed Singapore as an ideal location for a sister exchange to provide 24 hour global trading capability in certain financial futures contracts. Singapore, on the other hand, was seeking to revive and expand its futures market and to revamp the moribund Gold Exchange of Singapore ("GES").[19]

Singapore's experience of an open outcry futures market could be traced to a domestic gold futures market which was established in 1978 under the aegis of the GES.[20] By September 1982, 24 gold futures trading firms, some of whom were members of the GES, were under investigation for malpractices and abuses in gold trading.[21] 21 of these gold futures trading firms were subsequently wound up in September 1983 and there was one successful prosecution of an individual for criminal breach of trust.[22]

On the face of it, the short history of the GES plagued by scandals did not appear conducive to the establishment of a financial futures market in Singapore which would inspire confidence amongst international investors. Ironically, it was the humble realization of the need to restructure the GES and to adopt a more sophisticated system of trading and regulation in order to regain or inspire such

[18] See generally Chapter 3, Chia & Soh, *SIMEX and the Globalisation of Financial Futures*.
[19] See Chapter 1, note 14, *supra*.
[20] See generally Chapter 1, Chia & Soh, *SIMEX and the Globalisation of Financial Futures*
[21] See generally Chapter 4, *ibid*.
[22] See *Loh Shak Mow v. Public Prosecutor* [1987] MLJ 362.

confidence amongst international investors, that led to the birth of SIMEX under the close guidance of the CME.

SIMEX which was established on 21 September 1983 was conceived as a partner of the CME in an east-west linkage through an unprecedented mutual offset system. Therefore, SIMEX began its life as the co-pioneer, together with the CME, of the world's first mutual offset system,[23] whereby contracts traded on one exchange could be cleared on the other exchange. With a mutual offset arrangement, market users in either Chicago or Singapore could have access to two markets to do their trading, but are obliged to deal with only one exchange, be it the CME or SIMEX, for paperwork relating to accounts, reports and margin settlements. This would allow market users a functional and cost effective way to trade around the clock.

Although SIMEX began conducting trading on 7 September 1984, the FTA was not passed until 1986. It was foremost in the legislators' minds that the gold scandals of the early 1980s were to be avoided. Said Dr Hu, the Minister of Finance, during the Second Reading of the Futures Trading Bill in 1986:

> "In the absence of any legislation regulating futures trading, there would be no strong deterrent to prevent other companies from being set up to repeat the activities of the early 1980's."[24]

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[23] For details of the mutual offset system, see the Agreement for the Creation of a Mutual Offset System between CME and SIMEX dated 28 June 1984.
[24] See Singapore Parliamentary Debates, vol. 47 at col. 1433 (31 March 1986).

It was blatantly clear which legislative framework the Singapore legislators were decided on emulating. Dr. Hu continued to state:

> "…the [Futures Trading] Bill has been modelled on the United States' Commodities Trading Act [sic][25] so that we can follow as closely as possible within our laws trading practices as conducted in the United States because of the linkage between SIMEX and the Chicago Mercantile Exchange. We have to be able to assure American investors that the laws we apply here for futures trading are similar to the laws in which they are familiar with."[26]

Apart from being a partner in an innovative mutual offset arrangement, SIMEX made headway as the first financial futures exchange in Asia or rather the first futures exchange in Asia to specialize in financial futures.[27] It does not appear ever to have been intended that SIMEX would be a futures exchange dealing exclusively in financial futures. One of SIMEX's first traded contracts was in gold futures. Gold, by any semantic gymnastics, is not a financial instrument.[28] Neither is oil. In 1989, SIMEX became Asia's first energy futures market with the introduction of the High Sulphur Fuel Oil futures trading.[29] Since 1995, Brent Crude Oil futures have been traded on SIMEX pursuant to another mutual offset agreement in effect between SIMEX and the International Petroleum Exchange ("IPE"). Therefore, SIMEX's self-proclamation[30] as a financial futures exchange is

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[25] This should be the Commodity Exchange Act.
[26] See Singapore Parliamentary Debates, vol. 47 at col. 1439 (31 March 1986).
[27] Following suit, the Hong Kong Futures Exchange was established in 1985 and the Tokyo International Financial Futures Exchange in 1989. The Osaka Securities Exchange, which was established in 1949, began trading Nikkei 225 futures contracts in 1988.
[28] This was acknowledged in the definition of "commodity" in s. 2, FTA.
[29] See the section "Underlying Commodity" at Chapter 3.
[30] In many of its promotional materials. For example, in its "Contract Specifications" booklet, SIMEX is introduced as the "first financial futures exchange in Asia."

inaccurate and incomplete. SIMEX may essentially trade any contract approved by the MAS.[31] As a business entity, it is a matter of course that SIMEX would aim to trade any contract that is commercially feasible to do so.

4. Economic Functions of Futures

Hedging Tool

Futures were conceived primarily as hedging tools.[32] This is by far the most recognized and often cited economic function of financial futures trading. This "hedging function" was explicitly acknowledged by the Singapore legislators:

> "Futures contracts enable a person to predetermine the price he has to pay or will receive for a commodity which he is liable to purchase or sell at a later date. This permits him to protect himself against potential price fluctuations."[33]

Hedgers are necessarily entities who have an interest in or a pre-existing risk associated with the underlying commodity of a futures contract. In the case of financial futures, these would be banks, financial institutions, insurance companies and other individuals or organizations who have assets or stock-in-trade in the form of foreign currency, interest rate instruments or stocks and shares. Indeed,

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[31] See the definition of "futures contract" in s. 2, FTA and s. 4A, FTA.
[32] Originally, producers of agricultural products protected themselves from volatile agricultural prices by using agricultural futures. The basic principle of hedging can be extended to any product, tangible or intangible, which is exposed to volatility in price.
[33] Said Dr Hu at the Second Reading of the Futures Trading Bill, Singapore Parliamentary debates, vol. 47 at col. 1431 (31 March 1986).

any entity involved in asset and liability management will have potential for the use of financial futures.

Futures trading, however, would only be an effective hedging tool if another party would voluntarily assume the risk that hedgers seek to hedge. The pre-existing risk perceived by hedgers is inevitably founded upon a prediction of a downward movement in the market of the underlying commodity. There is the risk that the value of the commodity held or to be produced or obtained by a hedger might fetch a lower price in the future. A futures contract would guarantee the hedger a certain price in the future for that commodity. A party willing to take the opposite position of a hedge would necessarily be taking the view that prices for that particular commodity will rise, and that buying at the hedger's predetermined selling price at the future date would be a "good buy." A party willing to take such an opposite view to a hedger is oftentimes a speculator.

Financial futures markets enable the risk associated with price volatility to be isolated from other types of business risk. Such risk is then transferred from risk averse hedgers to others who are willing to assume that risk, in order to earn returns if the odds are in their favour. In the absence of a futures market, this risk associated with price volatility could not be managed as efficiently or adjusted to an acceptable level. As a result the cost-of-risk to society would be higher, and it is said, we would all be worse off.[34] Hedging can therefore be seen as a social benefit provided by futures trading.

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[34] See Section 1.6, Franklin R. Edwards and Cindy W. Ma, *Futures and Options*, 1992, Mc-Graw Hill, Inc.

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[34] See Section 1.6, Franklin R. Edwards and Cindy W. Ma, *Futures and Options*, 1992, Mc-Graw Hill, Inc.

Insofar as holders of certain assets like foreign currency, interest rate instruments or stocks and shares are concerned, it may be more attractive to hedge one's positions using futures contracts than to liquidate the underlying positions. This may be due to the fact that transaction costs associated with financial futures are often lower than those associated with liquidating various financial assets. Furthermore, the assetholder may not be allowed to liquidate its assets because of factors such as regulatory constraint or tax implications.

Price Discovery

Price discovery is the revealing of information about future cash market prices through the futures market. This is the second most often cited economic function of financial futures trading. As the theory goes, the futures price is related to the cash market or spot price at the date in the future on which the futures contract expires. In other words, the cash market price at a future date can theoretically be predicted through calculations based on present futures prices. Futures markets therefore serve a purpose by assisting businesses make better estimates of future cash market prices so that they can tailor their consumption and pricing or investment decisions accordingly.

In essence, the futures market effectively processes the diverse opinions of a myriad of buyers and sellers which in turn is based on all available market information, and crystallizes the mass of market sentiment into discernible prices which are then accessible to the public. This price is disseminated for the benefit of all market participants to base their commercial decisions. Said Dr. Hu at the Second Reading of the Futures Trading Bill:

> "In addition to [the] hedging function, futures contracts perform another economic function, that of price dissemination. As trading in futures contracts is carried out in a centralized location, this leads to a wider dissemination of price information which results in more efficient markets."[35]

Speculation

As discussed above, a market consisting solely of hedgers would be illiquid and ineffective. Traditionally, speculation is not perceived to serve any economic function.[36] Indeed, financial futures have been given a bad name because of the activities of speculators in the market, the most infamous of them all being Leeson. It is undeniable that trading futures is a cheap and easy way for speculators to make bets on the future prices of various commodities. To the speculator, the commodity itself is insignificant and the only objective of trading activity is to profit from price changes.

Hedging and price discovery and dissemination are usually cited as the two important economic functions of futures trading. Speculation, on the other hand, can only be edified as a necessary evil. Speculation, at its most basic level, is

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[35] See Singapore Parliamentary Debates, vol. 47 at col. 1431 (31 March 1986).
[36] The legislators in Singapore were keen not to encourage speculative activity in futures. See Chapter 1, note 19, *supra*.

indistinguishable from gambling and moral and legal objections to gambling are not unfamiliar.

When disputes over financial futures first surfaced in the courts, there was some controversy in common law systems as to whether they were gaming and wagering contracts and therefore illegal.[37] Gaming and wagering contracts are illegal in Singapore by virtue of s. 6 of the Civil Law Act[38] which provides that agreements by way of gaming or wagering shall be null and void and that action cannot be brought to recover any money alleged to be owing upon the wager. However, s. 6(4) of the Civil Law Act specifically provides that "where any contract for the future delivery of any commodity is entered into by one or both parties with no intention of actual delivery of the commodity but with the intention of realising a profit arising out of differences in the price of the commodity shall not affect the validity or enforceability of the contract." As a complement, the FTA has also made it clear that financial futures are not gaming and wagering contracts. S. 58 of the FTA expressly states that "a futures contract made at a futures market…shall not be regarded as a contract of gaming or wagering."

[37] For a discussion of this topic under English law, see Dr David A. Chaikin and Brendan J. Moher, "Commodity Futures Contracts and the Gaming Act" (1986) LMCQ 390. In the UK, it is now expressly provided in the Financial Services Act that contracts in respect of investments, which include commodity futures, shall not be void or unenforceable by reason of the Gaming Acts.

[38] Cap. 43, Statutes of Singapore.

CHAPTER 3

DEFINITIONS OF TERMS

1. FTA and CEA

As mentioned earlier, the main legislation governing the futures industry in Singapore is the FTA which is acknowledged explicitly by the Singapore legislature to be modelled on the Commodity Exchange Act[1] ("CEA") of the US. However, Singapore's regulatory regime based on the FTA is noticeably different from the US regulatory regime based on the CEA and headed by the CFTC. For a start, the CFTC is a specially formed governmental agency,[2] established under the CEA, whose prime responsibility is to oversee futures trading, inclusive of financial, agricultural and metallurgical futures. There is no equivalent specialist regulatory body in Singapore. Under the FTA, the MAS is given the responsibility of overseeing the financial futures industry. The MAS, under various other pieces of legislation, is also given the responsibility of overseeing the banking, insurance, finance companies and securities industry in Singapore.[3]

The most fundamental distinction between the market governance regimes of Singapore and the US lies in the markets intended to be governed. The US futures market sought to be governed by the CFTC clearly embraces *all* futures

[1] US Code, Title 7, Chapter 1.
[2] The CFTC was created by the US Congress in 1974 as an independent agency with the mandate to regulate futures and options markets in the US. On April 21, 1995, President Clinton signed into law the CFTC Reauthorization Act of 1995, reauthorizing the CFTC to the year 2000.
[3] See "The MAS" at Chapter 4 below.

contracts, and does not limit itself to futures contracts based on financial instruments. In Singapore, the primary focus of the FTA is on futures contracts based on gold and financial instruments. The FTA is complemented by the Commodity Futures Act ("CFA")[4] which regulates commodity futures trading in Singapore and the government body responsible for overseeing such trading under the CFA is the Trade and Development Board ("TDB").[5] Singapore has only one commodity futures exchange authorized by the TDB under the CFA. The Singapore Commodity Exchange ("SICOM") trades futures contracts in rubber and coffee.[6] Futures contracts relating to commodities other than rubber and coffee are, at present, unregulated.[7]

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[4] Cap. 48A (1993 Rev. Ed.), Statutes of Singapore. The CFA is modelled very closely on the FTA. The differences arise largely because of the differences whereby trades are carried out on SICOM and SIMEX. SICOM does not use the open outcry method of trading. See note 6, *infra* and also see the Second Reading for the Futures Commodity Bill, Singapore Parliamentary Debates, vol. 59, cols. 1345-1348 (20 March 1992).

[5] The TDB was established in 1983 under the Trade Development Board Act, Cap. 330, Statutes of Singapore.

[6] It is not within the ambit of this paper to consider the jurisdiction of the TDB, SICOM and commodity futures trading in Singapore. Suffice it to say that at present SICOM trades only four rubber contracts and one coffee contract. SICOM was initially known as the Rubber Association of Singapore ("RAS") Commodity Exchange or the RASCE. In February 1994, the RASCE was renamed SICOM. Rubber contracts have been traded in Singapore since the 1920s but such trading had never been based on an open outcry system. A market making or "whispering" system where transactions were executed over the telephone instead of in a centralized trading pit was used instead. SICOM now provides a computerized trading system.

[7] S. 2, CFA defines "commodity" to mean "rubber and such other produce, items, goods and articles which are the subject of commodity futures contracts, as the Board may by order prescribe, and includes indices, rights and interests in such commodity." The Commodity Futures (Coffee) Order 1995, S 65/95, which came into effect on 1 March 1995, prescribed coffee as a "commodity" for the purposes of the CFA. Said BG Lee Hsien Loong, the then Minister of Trade and Industry at the Second Reading of the Commodity Futures Bill, Singapore Parliamentary Debates, vol. 59 at col. 1346 (20 March 1992):

> "At present, the scope of the Bill is limited to regulating trading in rubber futures contracts. Other commodity futures contracts will be prescribed as and when they become commercially viable. Until this is done, futures trading based on other commodities, for example, coffee or red beans, will not be regulated by the law. Persons who trade with broking firms offering such facilities have to bear the risks involved themselves."

In the US, the CFTC seeks to oversee futures trading as a form of economic activity.[8] It matters not what the underlying commodity of the futures contracts is, be it frozen concentrated orange juice, pork bellies, silver, copper, Eurodollars or JGB's. It is recognized in the CEA that the trading of all types of futures "are affected with a national public interest".[9] Unlike Singapore, the US is an extensive country with natural resources, and itself produces and processes many agricultural commodities. As manufacturers, the country utilizes many agricultural and metallurgical commodities. Therefore, the prices of such commodities which may be affected by the futures trading thereof is of paramount concern to the authorities.

The Singapore scenario is markedly different. The MAS seeks to oversee futures trading as a specific form of economic activity mainly where the underlying commodity of such futures is a financial instrument. Futures trading in coffee beans and rubber, and for that matter, soya beans or rice, is not a concern of the MAS. However, the possible impact that futures trading in equity indexes, foreign exchange and interest rates might have on the underlying financial instruments themselves and consequently on "monetary stability and credit and exchange conditions"[10] suggests that financial futures trading should be an area of major concern for the MAS. The MAS's wider concern can be said to be the wholistic

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[8] This is highlighted at §1.01, Philip McBride Johnson and Thomas Lee Hazen, *Commodities Regulation*, 1989, Little Brown and Company.

[9] Sec. 3, CEA continues to state: "The transactions and prices of commodities...are susceptible to excessive speculation and can be manipulated, controlled, cornered or squeezed, to the detriment of the producer or the consumer and the persons handling commodities and the products and byproducts thereof...rendering regulation imperative for the protection of such commerce and the national public interest therein."

[10] See s. 4(b), Monetary Authority of Singapore Act and also see Chapter 4, note 3, *infra*.

preservation of total financial market integrity, credibility and stability in Singapore. The governance of financial futures trading is but one aspect of this total market governance philosophy.

In this respect, it is anomalous that the trade of oil and gold futures also comes under the purview of an authority and regime designed for financial markets. This can be explained by the fact that SIMEX's infrastructure is one that can sustain trading in oil and gold futures. SIMEX is modelled on the CME and thereby has a trading system similar or familiar to many international exchanges who deal in financial and commodity futures. Trades in oil or gold futures cannot be sustained on SICOM which is a smaller exchange, with a smaller clientele base and which does not use the open outcry method of trading.[11] As a business entity, SIMEX would aim to trade any contract that is commercially feasible. The regulatory regime allows such flexibility. SIMEX may essentially trade any contract approved by the MAS.[12]

Upon comparing the US and the Singapore regulatory regimes, the maturity of the US's regime is evident. The CEA is a detailed and comprehensive collection of legislation aimed at the futures market since 1922. The CEA exceeds the FTA with regards to length and content. Although the CEA only has 48 sections, they are lengthy and detailed, having to cater to a regime that covers financial and commodity futures as well as a trading community spanning the whole

[11] See notes 4 and 6, *supra*.
[12] See s. 4A, FTA.

of the US. The FTA is comparatively shorter.[13] However, it is the FTR that stands in stark contrast to the body of general regulations made under the CEA. The FTR contains no more than 30 regulations[14] whilst its US counterpart boasts over 500.[15]

The FTA is necessarily at variance with the CEA in various aspects. For instance, the CEA covers the futures trading of virtually anything, tangible and intangible. Insofar as the FTA is concerned, although the FTA focuses on the regulation of financial instruments or intangible products, tangible products such as oil may be prescribed and added on the list by legislative action. There is no check or limitation as to what products can be added on by prescription. Certainly, it is not limited to products of a financial nature. Further, the CEA covers the futures trading of futures contracts whether traded on an exchange or not. As will be discussed, the FTA's position on off-exchange products remains uncertain.

There is still much ambiguity as to the extent of economic activity which the FTA seeks to regulate and in attempting to ascertain that extent, an examination of the US regime which it sought to emulate might provide some insight. After all, the blatant legislative intent behind the FTA was to model the Singapore regime on the US regulatory regime. This legislative intent may be

[13] Although the FTA has almost 70 sections, it is shorter in length to the CEA.
[14] Indeed, prior to the Barings debacle, the FTR was comprised of only about two dozen regulations. A spate of amendments to the FTR in 1995 and 1996 raised the number of regulations to about 30.
[15] See from ¶2001, "Regulations", *Commodity Futures Law Reports*, Commerce Clearing House, Inc.

taken into account by the courts in interpreting the scope of the FTA.[16] However, blind emulation of the US model for the sake of emulation is as unpalatable as it is ridiculous. The greater legislative object and purpose of the FTA is "to ensure that our futures market is operated properly and that the public interest is preserved."[17] The problem is, what did the legislature mean by "futures market"?

It should always be borne in mind that the focus of the Singapore regime stands in stark contrast to that of the US. Different socio-economic conditions exist. Different socio-economic considerations have to be taken into account. Indeed, various provisions in the CEA had not been adopted for Singapore use. The challenge for legislators and regulators is to develop an autochthonous governance infrastructure to suit Singapore's idiosyncratic socio-economic climate and culture, with the help of lessons learnt from the US's mature experience.

2. Underlying Commodity

The FTA at provides a definition of "commodity" as being:

"in relation to a futures contract -

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[16] There is no longer any controversy regarding the use of parliamentary materials as extrinsic aids by courts in interpreting legislation. The Interpretation Act, Cap. 1, Statutes of Singapore, was amended in 1993 to provide that in the interpretation of statutory provisions, the legislative intent, as manifested in parliamentary debates, explanatory statements to bills and other relevant materials, may be referred to. It directs courts to give statutory provisions an interpretation which would promote the object or purpose underlying the statute. For further discussion on this point, see Robert C. Beckman and Andrew Phang, "Beyond *Pepper v. Hart*: The Legislative Reform of Statutory Interpretation in Singapore," *Statute Law Review*, vol. 15, no. 2, 1994.

[17] See Second Reading of Futures Trading Bill, Singapore Parliamentary Debates, vol. 47 at col. 1433 (31 March 1986).

(a) a financial instrument; and

(b) gold and such other items, goods, articles, services, rights and interests, which are the subject of futures contracts, as the Authority may by order prescribe".[18]

Pursuant to the second leg of the definition, the Futures Trading (Commodity)[19] Order came into effect on 3 January 1989. It prescribed that all classes of oil be considered a commodity for the purposes of the FTA. It is the only order prescribing a good, article service, right or interest as a "commodity" made to date.

Financial instruments are automatically commodities for the purposes of the FTA. "Financial instruments" are defined in the FTA to "include currencies, interest rate instruments, share indices, a group or groups of share indices and such other financial instruments as the Authority may by order prescribe."[20] The use of the word "include" in the definition of financial instruments incontrovertibly means that the list is not exhaustive. Foreseeably, a problem may arise if a particular instrument is difficult to characterize, for want of being distinctively "financial". This problem is academic if the said instrument is to be subject to futures trading on SIMEX. For a futures contract to be listed on SIMEX, the MAS's approval is required.[21] In the course of approval and listing, one would expect the MAS to make an order prescribing the instrument as a "commodity" if the position is

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[18] See s. 2, FTA.
[19] S 417/88
[20] See s. 2, FTA.
[21] See s. 4A, *ibid.*

unclear or it could be safely assumed that such an instrument is indeed a "financial instrument." Upon approval and listing, the MAS is estopped from asserting any other position.

There may be occasions, however, when the problem is not purely academic. A futures broker is required under the FTA to be licensed.[22] A futures broker is one who carries on the business of soliciting or accepting orders, for the purchase or sale of any commodity under a futures contract on a futures market in Singapore or elsewhere.[23] If a corporation engages in soliciting or accepting orders for the purchase or sale of futures contracts based on re-insurance contracts and such futures contracts are listed on an overseas exchange, would the corporation concerned have to be licensed as a futures broker?[24]

The question would turn on whether re-insurance contracts are considered financial instruments. The uncertainty could be resolved by the prescription of re-insurance as a "commodity" by the MAS, as it is without doubt, either a service,

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[22] See s. 11, *ibid* and also "Market Entry Requirements" in Chapter 5 below.

[23] See s. 2, *ibid* and the definitions of "futures broker", "futures contracts" and "futures market" therein.

[24] Where the position is unclear as to whether the subject of a futures contract is or is not a financial instrument, a corporation dealing in the same cannot be clearly faulted for not complying with requirements under the FTA, for example, licensing and minimum financial requirements, accounts and audit requirements, segregation of customer monies or the provision of risk disclosure statements to customers. It is interesting to hypothesize what would happen if losses on such contracts were incurred by a customer. Action would be taken against the customer by the corporation broking the futures contracts. The customer would, as a measure of desperation, pursue a defence of illegality. Such a defence would argue that the underlying commodity of the futures contract is a financial instrument and therefore, the said corporation dealing in the same should have been licensed. Since the broker was not licensed, the contracts to purchase or sell futures contracts could be illegal and void, and the customer is accordingly not contractually bound. This argument could have some force since the FTA has been recognized by the courts to be legislation designed to protect the public. However, this is assuming the customer is not *in pari delicto*. See *Tokyo Investment Pte Ltd & Anor v. Tan Chor Thing* [1993] 3 SLR 170.

right or interest under the second leg of the "commodity" definition in the FTA. However, short of such a prescription being made, the issue remains unresolved. It might be of assistance to note at this stage that the regulation of insurance companies falls within the regulatory umbrella of the MAS,[25] and to interpret a re-insurance contract as a financial instrument would not be overly strenuous as a matter of semantics. Such an interpretation would not conflict with the MAS's overall regulatory objectives and policy. Considering the fact that the MAS is also the overseer of insurance companies, re-insurance may not have been such a good example of an instrument which sits on the fence of what is popularly conceived as a "financial instrument."

Perhaps a more difficult example would be that of a futures contract based on a property index.[26] Would a property index be considered a financial instrument for the purposes of the FTA? There is a view amongst practitioners that an index, whether based on property or potatoes, would be considered a financial instrument. This is consistent with the view that stock indexes are considered financial instruments, whereas individual stocks and shares are not.[27]

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[25] See "The MAS" at Chapter 4 below.

[26] These examples are not farfetched. The Futures and Options Exchange ("FOX") in London was "unable to fire the market's imagination with property-based futures". On the other hand, "the introduction of re-insurance based futures in the United States has occurred. The market will study the arrival of this newest contract class with interest because of the huge potential of the insurance market." See M. Desmond Fitzgerald with Catherine Lubochinsky and Patrick Thomas, *Financial Futures*, 2nd edition, 1993, Euromoney Books at 13.

[27] It remains to be queried whether a rubber index would be considered a "financial instrument" under the FTA. The CFA's definition of a "commodity" would indisputably include a rubber index. See note 7, *supra*. Would a broker who proffers futures contracts based on a rubber index have to be licensed both under the FTA and the CFA? It appears so.

In contrast, the CEA has an exhaustive definition of "commodity" that begins by itemizing commodities ranging from wheat to frozen concentrated orange juice and ends with the catch all phrase "all other goods and articles, except onions[28]..., and all services, rights and interests in which contracts for future delivery are presently or in the future dealt in."[29] The CEA's definition of "commodity" encompasses virtually anything that is or becomes the subject of futures trading, tangible or intangible.[30] The status as a "commodity" under the CEA does not emerge until the good, article, service, right or interest becomes the subject of futures trading. There is no requirement of added CFTC prescription. Wrote Johnson and Hazen in their important work, *Commodities Regulation*, of this:

> "Although this method of converting something into a commodity may seem curious, it illustrates an important principle of commodities regulation: Its interest is in a *form of economic activity* rather than in the attributes or character of the underlying subject. The economic activity in question is futures and commodity options trading; the nature of the commodity does not affect the regulatory result"[31]

In Singapore, the nature of the commodity *does* affect the regulatory result. Insofar as the nature of the commodity is a financial instrument, it would be within the purview of the FTA. In determining whether a product is a financial instrument, it is necessary to look at the wider objective of regulation and consider

[28] Futures contracts on onions were prohibited in 1958 because of a perceived adverse effect that futures trading had on cash crop prices. See note 3, §1.10, Johnson and Hazen, *Commodities Regulation.*
[29] See Sec. 1a(3), CEA.
[30] See §1.01, Johnson and Hazen, *Commodities Regulation.*
[31] See §1.01, *ibid.*

the contemplated regulatory embrace of the MAS. An opportunity may arise soon to consider this point as the futures business is a highly innovative one, and new products are constantly being tested on the global marketplace.

3. Futures Market

The FTA defines "futures market" as:

> "(a) a market, an Exchange or other place, whether in Singapore or elsewhere, at which trading in futures contracts regularly takes place; or
>
> (b) an electronic system, whether operating in Singapore or elsewhere, through which trading in futures contracts is carried out..."[32]

To define a futures market as a "market.. at which trading in futures contracts regularly take place" inevitably leads to a host of interpretive problems, especially when a "futures contract" is then essentially defined as a contract made pursuant to the rules or practices of a futures market! A futures market is where futures contracts are made, and futures contracts are contracts made on futures markets. That, is a précis of what the relevant legal definitions in the FTA have to offer.

So, what constitutes a futures market? This question is pertinent in the case of contracts which have many of the characteristics of a futures contract, for

[32] See s. 2, FTA.

instance, a standardized forward contract, save that they are not traded on a futures exchange either in Singapore or elsewhere. Standardized forward contracts could be regularly and systematically traded amongst a select group of persons. Assuming that the subject of the contracts is incontrovertibly a "commodity" under the FTA, whether such contracts would be considered "futures contracts" under the FTA would depend on their being traded according to the rules or practices of a "futures market" whatever that may be. Would a systematic off-exchange trading environment wherein standardized forward contracts are regularly transacted in accordance with rudimentary and crude, or even complex and advanced, rules and practices constitute a market?

If indeed a "futures market" is constituted, a contract where "one party agrees to deliver a specified commodity...to another party at a specified future time and at a specified price payable at that time pursuant to...the business rules or practices of [a]...futures market," becomes a "futures contract" for the purposes of the FTA. Two drastic consequences thereby ensue. First, those accepting or soliciting orders for futures contracts or advising on futures contracts on such a market without a licence from the MAS would be infringing the licensing provisions[33] under the FTA which results in the commission of an offence resulting in a fine or imprisonment or both. Next, it is also an offence resulting in a fine or

[33] S. 11, FTA in relation to "futures brokers", and s. 12, FTA in relation to "futures trading advisors" and "futures pool operators". The stipulated penalty in s. 11(3) and s. 12(4) is a fine not exceeding $30,000 or imprisonment for a term not exceeding 3 years or both. See "Market Entry Requirements" at Chapter 5 below.

imprisonment or both to "establish or maintain" a futures market in Singapore that is not approved by the MAS.[34]

Essentially, the question may be reduced to whether the word "market" in the definition of "futures market" connotes "a place where a number of persons or companies or businesses operate" or whether it is "the more abstract concept of a market created by the activities of a number of competitors."[35] This was a question considered by the Supreme Court of Australia in *Carragreen Currencies Corporation Pty Ltd v. Corporate Affairs Commission of New South Wales.*[36] Hodgson J concluded that the definition of "market" related to the former, being a physical place rather than an abstract concept.

The resolution of what a "futures market" is under the FTA has practical ramifications. Banks and financial institutions in Singapore regularly partake in off-exchange contracts for the forward delivery of interest rates or foreign exchange. These are otherwise generically known as OTC or "over-the-counter" derivatives. If the term "futures market" is an abstract notion, players in the OTC market could conceivably be caught by the FTA, particularly with respect to popular transactions where contracts are fairly standardized and constantly traded. On the other hand, if the narrow interpretation of a "futures market" is espoused, the swap market which has no physical marketplace would not constitute a "futures

[34] See s. 3, FTA. The stipulated penalty in s. 3(3) is a fine not exceeding $30,000 or imprisonment for a term not exceeding 3 years or both. The offence will be further discussed below. See note 54, *infra*.
[35] Hodgson J, *Carragreen Currencies Corporation Pty Ltd v. Corporate Affairs Commission of New South Wales*, (1986) 7 NSLR 705 at 721C-D.
[36] (1986) 7 NSLWR 705.

market". It may be sensible to conclude that the FTA does not apply to the off-exchange market in which many large and sophisticated institutions who do not need the protection of the FTA participate. However, such a conclusion would necessarily disapply the FTA to schemes which market similar forward contracts as vehicles for speculation. Betting on interest rates, foreign currency or even oil prices may be cheaply done by the use of forward contracts. Delivery of the underlying commodity would not be required as speculators offset forward contracts by entering into an equal but opposite contract. In the US, various such schemes involving purely speculative contracts in gasoline, coal, precious metals and foreign currency have been devised and have become the subject of injunction proceedings by the CFTC.[37]

Unfortunately, the US position does not assist in the interpretation of the phrase "futures market" or "market." The problem of defining a "futures market" does not arise in the US. Specific organized commodities markets are designated as "contract markets" under the CEA. Members of such "contract markets" would have to comply with the CEA and the requirements of their particular contract market. The CEA makes it unlawful for any person to deal in any transaction in or in connection with "a contract for the purchase or sale of a commodity for future

[37] See *CFTC v. Co Petro Marketing Group, Inc*, 680 F.2d 573 (1982). Co Petro had marketed speculative contracts for the future purchase of petroleum products extensively to the general public through newspaper advertisements, private seminars, commissioned telephone solicitors and various other commissioned sales agents. For further examples, see *CFTC v. National Coal Exchange, Inc*, Comm. Fut. L. Rep. (CCH) ¶ 21,424 (1982), and *CFTC v. Noble Metals International, Inc*, 67 F.3d 766 (1995), both instances of off-exchange contracts for the future delivery of coal and precious metals respectively which were marketed to members of the general public and *CFTC v. Standard Forex, Inc*, Comm. Fut. L. Rep. (CCH) ¶ 26,786 (1996), where contracts to buy or sell British pounds were marketed to members of the general public, notably Chinese and Korean immigrants. The contracts in the above cases were held by the courts to be futures contracts for the purposes of the CEA were thus subject to the "contract market monopoly."

delivery"[38] unless such transaction is conducted on or subject to the rules of a contract market[39] and is executed or consummated by or through a member of such contract market.[40] This so-called "contract market monopoly"[41] extends to all contracts for future delivery, even to those not "on or subject to the rules of" a contract market, thereby covering all privately created non-exchange traded forward contracts.[42] Such an approach assures that anyone dealing in any contracts for the purchase or sale of any commodity for future delivery is a market participant regulated under the CEA. This approach is necessarily wide-ranging and is pared down by exemptions. For instance, to prevent banks and financial institutions who engage in forward transactions in foreign currency from being caught out, an exception for large, sophisticated financial institutions was worked into the CEA.[43]

The *Carragreen* case appeared at first blush to offer some insight into the question of what a "futures market" or "market" is in lieu of similarly worded futures legislation in Australia. However, it is submitted that *Carragreen* is of limited applicability in Singapore as the definition of "futures market" in the Australian legislation contains an important difference. The definition of "futures

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[38] See sec. 6(a), CEA.
[39] See sec. 6(a)(1), *ibid.*
[40] See sec. 6(a)(2), *ibid.*
[41] See § 1.06, Johnson and Hazen, *Commodities Regulation.*
[42] See *ibid.*
[43] This exemption is known as the Treasury Amendment, see sec. 2, CEA and see note 4 and §1.01, *ibid.* The scope of this exemption however has recently been the subject of controversy. On the one hand, the Treasury Amendment has been interpreted to exempt only off-exchange transactions in *inter alia* foreign currency amongst banks and large, sophisticated financial institutions, see *Salomon Forex, Inc v. Tauber*, 8 F.3d 966 (1993). On the other hand, it has recently been interpreted to exempt all off-exchange transactions in foreign currency, regardless of the nature of the participant, see *CFTC v. Frankwell Bullion*, 99 F.3d 299 (1996). This is further discussed in "Futures Contract" below.

market" in the Australian legislation includes the word "facility"[44] whereas the definition in the FTA does not.

In *Carragreen*, the plaintiffs were in the business of granting to its customers options to purchase certain types of foreign currency and had brought the action seeking declarations that its business did not breach the Australian Futures Industry Code. Apart from deciding whether the said contracts for the supply of foreign exchange at a future date at a price fixed at the time of entering into the contract were "futures contracts" as defined in the Futures Industry Code, the courts had to decide whether the infrastructure set up by the plaintiffs for business could be considered a "futures market". If a "futures market" existed, the plaintiffs would be in breach of the Futures Industry Code by having established and maintained a futures market that is "neither a futures market of a futures exchange or an exempt futures market."[45] The infrastructure of the plaintiffs comprised personnel, means of communication, access to relevant foreign currency market information, trading arrangements with brokers, as well as an office for general administration. It was held that such an infrastructure could not be considered a "market" for the word "market" connoted "a place where a number of persons or companies or businesses operate."[46] However, it was also held that an infrastructure like that of the plaintiffs could constitute a "facility" by means of which futures contracts are regularly made and that the office of the plaintiffs was a

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[44] S. 4(1) of the Futures Industry Code defines "futures market" as "a market, exchange or other place at which, or a facility by means of which, futures contracts are regularly made."
[45] See s. 45, Futures Industry (New South Wales) Code which was referred to as the Futures Industry Code by Hodgson J, see *Carragreen* at 711B.
[46] See note 35, *supra*.

"place" at which futures contracts were regularly made. The plaintiff's business enterprise, therefore, fell within the definition of a "futures market" as a "facility.".

Counsel for the plaintiffs in *Carragreen* had argued that "facility" must mean something of the nature of a market or exchange constituted by some sort of electronic network. In essence, he submitted a market should be where a number of persons compete otherwise it would be manifestly absurd and unreasonable to have a situation whereby a private party regularly making futures contract could be guilty of an offence which could result in imprisonment.[47] These arguments were summarily rejected as being "insufficient."[48] The rejection without reasoned riposte is perhaps unsurprising, if looked at in terms of regulatory policy. The net effect of the judgment was to catch the leveraged foreign exchange trading carried out by Carragreen Currencies Corporation Pty Ltd within the regulatory net, even if it meant stretching the meaning of the term "futures market".

It is interesting to note that if the impugned business of the plaintiffs in *Carragreen* were to be conducted in Singapore today, it would contravene the FTA without the need for any further discussion of whether such business was transacted on a futures market. The activities would be caught under provisions pertaining to "leveraged foreign exchange trading" which have been within the purview of the FTA since the round of FTA amendments in 1995.[49]

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[47] See *Carragreen* at 721D-F.
[48] See *ibid* at 721G.
[49] See "Leveraged Foreign Exchange Trading" below.

Leveraged foreign exchange trading need not occur on a "futures market" to be caught by the FTA, but on a "foreign exchange market." A "foreign exchange market" is then defined as a "market, whether in Singapore or elsewhere, at which foreign exchange trading regularly takes place."[50] It is clear the word "market" in this context is used in its abstract sense. In the Explanatory Statement to the Futures Trading (Amendment) Bill,[51] the term "leveraged foreign exchange trading" was expressed to mean "dealing in foreign exchange in the over-the-counter market on a margin basis." The question remains to be asked though: what is an over-the-counter market? When is it constituted?

Whether prior to the 1995 amendments, leveraged foreign exchange trading could have constituted a "futures market" would have been an interesting exercise in statutory interpretation for the judiciary. The definition of a "futures contract" is drafted widely enough to capture certain leveraged foreign exchange transactions, in particular, those that are standardized and have clear dates for delivery or offset. What is uncertain is whether such off-exchange transactions would have been made pursuant to the business rules or practices of a "futures market."

It has to be remembered that the legislative intent behind the FTA in relation to futures contracts was never to cast a wide net at futures trading *per se* as an economic activity. The FTA was not geared towards the "consumer" or "non-professional."[52] The legislature appeared more concerned with protecting the

[50] See s. 2, FTA.
[51] See Government Gazette Bills Supplement, no. 9 (24 January 1995) at 44.
[52] See Chapter 1, note 19, *supra*.

financial sector as a greater whole, rather than the gullible investor as an individual.[53] The FTA, modelled on the legislative regime of the US was specifically designed for the regulation of SIMEX, primarily to appease the CME and the CFTC. The regulatory focus was very much on exchange-traded contracts.

At this point, it is to be noted that s. 3 of the FTA provides that:

> "No person shall...establish or maintain or assist in establishing or maintaining or hold himself out as providing or maintaining a futures market in Singapore that is not the futures market of a Futures Exchange that has been approved by the Authority..."[54]

This is evidently aimed at preventing unapproved exchanges from being set up and the trade thereon of contracts similar to those traded on SIMEX, without any of the restrictions found in the FTA, FTR and the Rules. In order to give s. 3 of the FTA any bite, the restriction against establishing or maintaining a "futures market" should extend to cover the establishment or maintenance of a "market" in standardized forward contracts not necessarily involving transactions on an exchange. After all, what is an unapproved exchange or market?

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[53] Dr Hu, Minister of Finance, Singapore Parliamentary Debates, vol. 47, col. 1433 (31 March 1986) stated: "Trading in futures contracts based on commodities not listed on SIMEX...is not regulated under this Bill. It is not considered as yet appropriate for the MAS to regulate these other activities since they do not involve the financial sector. Broking firms that offer facilities solely in commodities futures are thus not subject to the regulations of this Bill and members of the public who trade with them will have to accept the risks involved in dealing with these firms."

[54] See note 34, *supra,* where the penalties are stipulated.

It is submitted that the *Carragreen* interpretation of the word "market" as denoting a physical place where buyers and sellers compete is too narrow. Although dictionaries tend to point towards a "place" for trade as the principal meaning of "market", it is undeniable that in modern English usage "market" can connote something more abstract, such as "conditions as regards, or opportunity for, buying and selling."[55] The FTA itself uses the word "market" clearly in its abstract sense in the second leg of the definition of "futures market" where an electronic system is described.[56] An electronic facility which does not permit users of the facility to "make a market in, futures contracts" is excluded from the definition.

At the end of the day, what constitutes a "futures market" is a policy question. The initial legislative thrust behind the FTA was to set up a regulatory framework for exchange-traded products of a standard comparable to that in the US, to instill confidence in the international investor. It is unlikely that the sophisticated international investor would be duped by get-rich-quick or investment schemes comprised of contracts resembling futures contracts save that they are not executed on an approved exchange. Neither would such investors be the target for the marketing efforts of the schemers. Where the marketing and trading of financial products reminiscent of futures contracts have led to

[55] From the definition of "market" in the Concise Oxford Dictionary.

[56] The second leg of the definition of "futures market" in s. 2, FTA reads in full as follows: "...an electronic system, whether operating in Singapore or elsewhere, through which trading in futures contracts is carried out; but excludes an electronic facility which merely provides price or other information on futures contracts (whether the facility is part of or carried on in conjunction with the provision of any other information not related to futures contracts) and which does not permit users of the facility to channel orders for, execute transactions in, or make a market in, futures contracts."

malpractices and scams of a pseudo-criminal nature which affect a large cross-section of society, the legislature has intervened, for instance, in the case of leveraged foreign exchange trading. This was probably a more economical and efficient method of dealing with the problem than to embark on lengthy and uncertain prosecutions of the offending "forex bucket shops" under the FTA with awkward arguments centered on what actually constitutes a "futures market" and thus a "futures contract."

Further reform is necessary, if indeed there is a policy intention behind the FTA to protect an evergrowing class of Singaporean society that is affluent yet unsophisticated as investors. Where the offer and trade of futures-type products are effected on such a scale as to affect the general public, a pragmatist might suggest that, as things now stand, a "futures market" would arise and the activity caught within the FTA. The ambiguities and uncertainties inherent in the definition of a "futures market" give the courts ample leeway. The execution of a few semantic gymnastic moves could metamorphose off-exchange trading arrangements into a "market." Factors like the fungibility and liquidity of the products traded could be taken into account, based upon the regularity and ease of trade, the reliability of the trading network, the number of participants, the centralization of administration, the method of price quotation, the concretization of rules and practices and the standardization of the products traded. However, this malleability of the meaning of "market" would ensure uncertainty and unpredictability. This might serve to protect the gullible investor, but it might not be conducive to the allure of international investors who thrive on legal certainty and predictability for commercial planning purposes.

Further, a wide, abstract and amorphous definition of "market" risks the capture of OTC trades between banks, financial institutions and other sophisticated and experienced participants who do not need the protection of the FTA. Indeed, the imposition of the FTA could arguably stifle such trades by increasing regulatory compliance costs. OTC derivatives trading in foreign exchange and interest rate instruments is an activity common to major financial centres. In a 1995 global survey coordinated by the Bank for International Settlements, Singapore was ranked the world's fourth largest trading centre for foreign exchange derivatives, the world's sixth largest interest rate derivatives market, and the world's fifth largest derivatives market overall with a daily volume of US$103 billion.[57] To stifle such activity would definitely *not* be the legislative intent behind the FTA. Although the trades in financial forward contracts may affect the monetary stability or economic policy of Singapore, the defence of which is clearly within the MAS's mandate, and would thus support a wide reading of "futures market" in the FTA, the empirical evidence is that no action has been taken so far against off-exchange transactions based on breaches of the FTA. Insofar as the OTC derivative market is concerned, most of the players involved, being banks and financial institutions, are regulated under other regimes, and fall within the jurisdiction of the MAS in any case.[58]

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[57] See "S'pore world's fourth largest forex derivatives market," *The Straits Times*, 20 December 1995 and "S'pore No 5 derivatives centre," *The Business Times*, 20 December 1995.

[58] See Banking Act, Cap. 19 and the Financial Institutions Act, Cap. 108, Statutes of Singapore.

4. Futures Contract

The FTA defines "futures contract" as:

"a contract the effect of which is that -

> (a) one party agrees to deliver a specified commodity, or a specified quantity of a specified commodity, to another party at a specified future time and at a specified price payable at that time pursuant to terms and conditions set forth in the business rules or practices of an Exchange or futures market; or
>
> (b) the parties will discharge their obligations under the contract by settling the difference between the value of a specified quantity of a specified commodity at the time of the making of the contract and at a specified future time, such difference being determined in accordance with the business rules or practices of the Futures Exchange[59] or futures market at which the contract is made,

and includes a futures option transaction".[60]

A contract which is traded on SIMEX, a futures exchange approved by the MAS, obviously falls squarely within the definition of a "futures contract." That much is clear. Similarly, a financial future traded on a foreign futures exchange falls within the definition of "futures contract." That much is also clear. What

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[59] "Exchange" and "Futures Exchange" have the same meaning in s. 2, FTA. There appears to be no reason for the use of two different expressions. The inconsistency is irksome but of no consequence.

[60] See s. 2, FTA.

remains unclear is the status of regularly traded off-exchange cash-settled forward contracts in which there is no intention of delivery of the underlying commodity. Such contracts are entered into for speculative purposes and could lead to substantial risk of losses, just like exchange-traded futures contracts. To participate in such contracts, the customer is asked to place an initial margin or deposit with the broker, and may be subject to additional margin calls. This participation on a margin basis is also known as leverage. At the end of the day, insofar as the customer is concerned, the impact of trading in either off-exchange contracts of the type described or that of exchange-traded futures, is similar. He could stand to lose more than the amount of money laid down as initial margin. If such off-exchange contracts are not considered "futures contracts" pursuant to the FTA, such a customer would lose all customer protection afforded by the FTA in its dealings with the broker. Insofar as off-exchange leveraged forward contracts in currency are concerned, the provisions in the FTA relating to leveraged foreign exchange trading have clarified the issue. However, the status of off-exchange leveraged forward contracts based on financial instruments other than foreign exchange, or commodities such as oil and gold, is still unresolved.

By defining "futures contracts" widely to encompass off-exchange transactions would be a step towards affording the public greater protection. When confronted with an affluent yet perhaps unsophisticated investing public, it appears sensible to regulate leveraged forward contract schemes marketed to the general public for speculative purposes. The legislature evinced opinions discouraging an on-exchange casino, it should be taken that they would have sought to discourage an off-exchange casino regarding contracts of the exchange-traded genre, had they addressed the issue. It would not serve any agenda to interpret "futures contract" narrowly whereby off-exchange schemes reminiscent of "futures contracts" may be marketed to the public.

The problem with this seemingly sensible approach is that a wide definition of "futures contract" embracing off-exchange transactions might unwittingly include into the ambit of the FTA the active and thriving off-exchange OTC derivative or swap market made up of large institutional or other sophisticated participants. These participants neither want nor need the protection of the FTA. Indeed, in the US, when an action[61] challenged a United States Court of Appeals to place the US derivative market under CFTC jurisdiction by holding that such derivatives were futures contracts regulated by the CEA, the courtroom was awash with *amici curiae* urging that "to regulate the traditionally unregulated markets, market efficiency would be reduced and innovation in the development of new mechanisms would be inhibited"[62] and that it "would result in extra-ordinary costs and would damage the United States' ability to compete as a world financial center."[63] The same concerns could be applicable in Singapore, a major centre for derivatives trading.[64]

In the US, the CEA has an inbuilt exclusion that disapplies the CEA to "transactions in foreign currency, security warrants, security rights, resales of

[61] See *Salomon Forex, Incorporated v. Laszlo N. Tauber, M.D.*, 8 F.3d 966 (1993).
[62] See *ibid* at 974.
[63] See *ibid*.
[64] See note 57, *supra*.

installment loan contracts, repurchase options, government securities, or mortgages and mortgage purchase commitments" if the transactions are effected between parties and are not traded for future delivery on an organized exchange.[65] The US Department of Treasury had urged this exclusion in 1974 on the ground that protections afforded by the CEA were not needed by large, sophisticated financial institutions who commonly trade amongst themselves in those instruments and in some instances, forward commitments having certain attributes typical of a futures contract might occur. This exclusion came to be known as the Treasury Amendment. This exclusion in the CEA is not replicated in the FTA, and it is submitted that the idea of excluding "sophisticated financial professionals" from the grasp of the FTA is a potential avenue of reform.

Unfortunately, the Treasury Amendment itself is worded ambiguously and does not spell out clearly the beneficiaries of the amendment. Does the exemption apply to banks only, or to other financial institutions as well, and even to individual foreign exchange traders? In *Salomon Forex, Incorporated v. Laszlo N. Tauber, M.D.*,[66] a surgeon from northern Virginia who traded in foreign currency on a large scale[67] argued unsuccessfully that the Treasury Amendment applied only to the interbank derivative market. It was his defence against claims made by Salomon Forex that the foreign exchange contracts he entered into with Salomon Forex were off-exchange futures contracts which violated the CEA, and were thereby

[65] See sec. 2, CEA and notes 4 and 5 in §1.01, Johnson and Hazen, *Commodities Regulation*.
[66] 8 F.3d 966 (1993).
[67] Tauber had entered into 2,702 foreign currency transactions with Salomon Forex, Inc. and related entities and also traded in foreign currency with more than a dozen other companies besides those of Salomon Forex. Furthermore, Tauber had a wholly-owned foreign currency trading company which held a seat on the Philadelphia Stock Exchange and was estimated himself to be worth over half a billion US dollars. See *ibid* at 969.

illegal and unenforceable. Unsurprisingly, the court opined that Salomon Forex and Tauber were both "sophisticated financial professionals"[68] and that the foreign exchange transactions fell within the Treasury Amendment and were legal. The court limited their interpretation of the Treasury Amendment to cover only transactions between participants of a certain, though undefined and unquantified, level of sophistication.[69]

In 1997 however, the court in *CFTC v. Frankwell Bullion Limited*[70] held that the Treasury Amendment exempted *all* off-exchange transactions in foreign currency regardless of the nature of the participant, since "[t]o hold...that the Treasury Amendment excludes only transactions between banks and other sophisticated investors would require this court to craft, without any support from the statutory language, some distinction between sophisticated investors and the general public."[71] The simple lesson to be learned from the interpretive confusion surrounding the Treasury Amendment is that any amendment to the FTA aimed at excluding transactions between "sophisticated financial professionals" should avoid the US precedent. A clear and unambiguous definition of what exactly sophistication means is imperative for the smooth working of an exemption.

Indeed, the idea of exempting traders who deal only with sophisticates has already been espoused in the FTA. In 1995, a definition of "accredited investor"

[68] See *ibid* at 977.
[69] See *ibid* at 978 where Niemeyer, Circuit Judge, who delivered the opinion stated: "We hold only that individually-negotiated foreign currency option and futures transactions between sophisticated, large scale foreign currency traders fall within the Treasury Amendment's exclusion from CEA coverage."
[70] 99 F.3d 299 (1996).
[71] See *ibid* at 304.

was inserted into the FTA. Persons who carry on the business of leveraged foreign exchange trading only with accredited investors are exempt from the licensing provisions of the FTA.[72] An "accredited investor" is defined as:

> "(a) an individual whose net personal assets exceed $5 million or its equivalent in foreign currencies; or
>
> (b) a corporation with net assets exceeding $10 million in value or its equivalent in value in foreign currencies as determined in accordance with the most recent audited balance sheet of the corporation."[73]

This provision was necessary to prevent certain foreign exchange dealers who only trade selectively with institutions and sophisticated individuals from being unwittingly caught under the licensing provisions. It is noted though that the threshold of minimum net worth of $5 million for an individual and $10 million for a corporation is rather high.[74] Nevertheless, the position regarding those who deal only with accredited investors in leveraged foreign exchange trading is clear. Uncertainty, however, still attaches to the status of dealers in derivative transactions based on financial instruments other than foreign exchange, as well as on other commodities recognized by the FTA, such as gold and oil.

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[72] See s. 2 and s. 11(2)(a), FTA.

[73] See definition of "accredited investor" in s. 2, *ibid*.

[74] This is particularly so when compared to the threshold in the definition of a "sophisticated investor" under the Companies Act, Cap. 50, Statues of Singapore. An offer of shares to sophisticated investors is exempt from various requirements under the Companies Act in relation to the offer of shares to the public. See s. 106D(2) of the Companies Act, where a "sophisticated investor" is defined, and where it is provided that the individual threshold is $1 million and that of a corporation is $5 million.

It is pertinent to note that in the US, the CEA does not provide a definition of "futures contract". As mentioned earlier, the CEA makes it unlawful to deal in "a contract for the purchase or sale of a commodity for future delivery" without being a registered participant on a recognized organized exchange. The CEA, however, provides that the term "future delivery" "does not include any sale of any cash commodity for deferred shipment or delivery."[75] The distinction between "future delivery" and "deferred delivery" is appreciably blur. The "cash forward exemption" may roughly be said to cater for customized forward contracts, undertaken neither for speculative nor hedging purposes, and which are not characterized by elements of fungibility and liquidity. In their work *Commodities Regulation*, Johnson and Hazen gave this explanation:

> "...the phrase future delivery eliminates transactions where an immediate sale occurs but where, for the convenience of the parties or otherwise, the actual transfer of the commodity is deferred. The primary focus of this exclusion, in historical context, was on a common practice in agricultural trade of making binding sales with postponed delivery; these arrangements frequently are referred to as forward contracts. For example, grain merchants would often commit to buy a portion of farmers' plantings in advance of harvest. The sales price was fixed immediately, both parties contemplated that the grain or produce would eventually be transferred, but delivery would have to await harvesting. In most cases, commitment was personal to the parties, and the obligation to deliver could be excused only with the other party's consent."[76]

[75] See Sec. 1a, CEA.
[76] At §1.03.

The narrow reading of the so-called "cash forward exemption" has been supported by the courts in a spate of cases, for instance, *CFTC v. Co Petro Marketing Group, Inc.,*[77] *Transnor (Bermuda) Limited v. BP North America Petroleum et al*[78] *and CFTC v. Noble Metals International, Inc et al.*[79] In determining whether a contract was a "futures contract" or a "cash forward contract", the cases suggest that a major factor to be taken into consideration is whether there is an intention to actually deliver the underlying commodity. Even if delivery is stipulated in the documentation, the courts would take into account the subjective intentions of the parties and preferred substance over form. The emphasis whether or not delivery occurs is not so important in Singapore. In the US, the intention to actually deliver may exempt a contract from CEA jurisdiction. In Singapore, the wording of the FTA is such that even if delivery actually occurs, such a contract could still well be a "futures contract" as futures contracts, by definition, can either result in delivery or cash settlement.

In the process of distinguishing between a futures contract and a cash forward contract, however, the US courts examined and attempted to articulate the nature of a "futures contract" as the term "futures contract" is not defined in the CEA. Even though the Singapore legislature adopted a definition of "futures contract" in the FTA, for the reasons mentioned, the definition is inadequate as it depends wholly on what a "futures market" is (which in turn depends on what a "futures contract" is). A fine tautological conundrum. It would be appropriate,

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[77] 680 F.2d 573 (1982).
[78] 738 F. Supp. 1472 (1990).
[79] 67 F.3d 766 (1995).

therefore, to look to the US courts' pronouncements on what a "futures contract" is for certain guidance.

Oft quoted is Canby, Circuit Judge in *CFTC v. Co Petro*, where he opined that in determining whether a particular contract is a "futures contract" over which the CFTC has regulatory jurisdiction, "no bright-line definition or list of characterizing elements is determinative."[80] He also stated that each "transaction must be viewed as a whole with a critical eye towards its underlying purposes," adding that the contracts at issue in the case "represent speculative ventures in commodity futures which were marketed to those for whom delivery was not an expectation."[81]

It is submitted that the standardization of terms, offsetting arrangements, no intention of actual delivery and the provision of participation on a margin basis in a forward contract are all factors which contribute to suggesting that a contract in question is a "futures contract." Such indications are neither absolute nor exhaustive. Difficult issues will arise depending on the particular facts and circumstances of each case. How standardized must terms be? In the *CFTC v. Co Petro*, it was acknowledged that while the contracts in issue were "not as rigidly standardized as futures contracts traded on licensed contract markets, neither were they individualized."[82] The court continued to state:

[80] See *Co Petro* at 581.
[81] See *ibid.*
[82] See *ibid* at 580.

should be regulated as a futures contract, is the level of marketing and participation. In *CFTC v. Co Petro*, *CFTC v. National Coal Exchange, Inc*,[84] *CFTC v. Noble Metals* and *CFTC v. Standard Forex*,[85] the CFTC had held that the impugned contracts were not cash forward contracts but futures contracts. What is a common factor of the cases is that all the contracts held to be "futures contracts" had been marketed to the general public. Indiscriminate and at times aggressive mass marketing to small investors was a characteristic of the various schemes. For instance, in the recent case of *CFTC v. Standard Forex*, Standard Forex advertised in Chinese and Korean periodicals and Standard Forex account executives targeted mainly Chinese and Korean immigrants who spoke English as a second language.[86] The court recorded tragically that "Standard Forex accounts almost uniformly lost money...the uncontroverted evidence demonstrates that in the aggregate the customers of Standard Forex lost approximately three-fourths of their investment over the lives of their accounts."[87]

The question then is how popularly marketed and participated must a contract be before it enjoys the status of a "futures contract." To include in the definition of "futures contract" the category of off-exchange transactions is not untenable, but as matters now stand, the definition does not provide a delimitation. In companies legislation, an offer of shares is considered a public offer if it is made to 50 persons or more, each of whom is a sophisticated investor.[88]

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[84] Comm. Fut. L. Rep. (CCH) ¶21,424 (1982).
[85] Comm. Fut. L. Rep. (CCH) ¶26,786 (1996).
[86] See *ibid* at ¶26,786.
[87] See *ibid*.
[88] See s. 106D, Companies Act.

The present state of the FTA is highly unsatisfactory. The situation in the US, unfortunately, is not much clearer. In *Transnor (Bermuda) Ltd v. BP North America Petroleum*,[89] 1990, it was held that 15-day Brent transactions did not constitute forward contracts excepted from the CEA, since the high levels of speculation and performance without delivery as well as the relatively standardized contracts, distinguish them from the forward contracts contemplated by the drafters of the CEA. The contracts in that case were undertaken mainly to assume or shift price risk without transferring the underlying commodity. However, *Transnor (Bermuda) Ltd v. BP North America Petroleum* dealt with the highly specialized international market in Brent Crude Oil made up of only over 100 active traders and brokers.[90] There was no evidence that the contracts were marketed to the general public. Indeed, the action in question was not taken by the CFTC. The suit was instituted by Transnor who had purchased cargoes of oil but refused to take delivery of the cargoes because the market value had declined after Transnor entered into the contracts. Transnor asserted that the defendants had *inter alia* violated the CEA.

As a renowned centre for oil refinery facilities, Singapore would conceivably have a trade in oil forwards occurring upon its shores. Would such contracts, entered into for a mix of both speculative and hedging purposes, be considered futures contracts within the jurisdiction of the FTA? It is submitted that it is neither wise in law nor economics to regulate a hitherto unregulated

[89] 738 F. Supp. 1472 (1990)
[90] See *Transnor* at 584.

market in oil forwards under a regulatory framework that was neither designed nor suited to do the job.

Purely speculative contracts marketed indiscriminately and widely by financially weak outfits are the sort of contracts that require paternalistic regulation for the sake of protecting the general public. These outfits have been called "bucket shops" and the CEA had sought to eliminate them in the US. In Singapore, it is clear that the legislature did not seek to eliminate them insofar as contracts based on commodities which were neither gold nor financial instruments were concerned. The position as to contracts based on financial instruments remains unclear. As discussed, "bucket shops" do not affect the sophisticated or the international investor. They do, however, affect the novice investor and it has been opined that speculation is an activity that should be discouraged amongst the general public. Akin to gambling, speculation arguably diverts the time, energy and resources of individuals from otherwise productive endeavours.[91] However, the fine line between investment and speculation is a hard one to draw. What is clear is that the unlimited danger of speculative forward contracts stands in stark contrast to the limited losses that could be sustained from investing in shares. Investing in shares could be a risky business, but due to the limited liability of companies, shareholders, at the most, lose the whole of their investment. In the case of forward or futures contracts, the speculator against whom the market has moved, is left with potentially unlimited losses. Those who sell and market off-exchange

[91] During the Second Reading of the Futures Trading Bill, vol. 47, col. 1438 (31 March 1986), Dr. Augustine Tan said in the context of SIMEX: "...with the availability of such a wide-range of instruments for speculation, a lot of time, energy and resources might be diverted from productive endeavours towards speculative endeavours to the detriment of Singapore's economy."

forward products essentially take a position against their customers. When the market moves against them, in an unregulated arena without minimum financial requirements to set up such businesses, they would simply buckle up and leave behind uncollectible debts. Rather than ask whether such products sold were "futures contracts," the apposite question is whether they ought to be "futures contracts."

5. Options on Futures

Since the definition of "futures contract" in the FTA includes a "futures option transaction", a short discussion of options is warranted. A "futures option transaction" is defined in the FTA as:

> "a transaction which gives a person a right, acquired for a consideration, to buy or sell within a specified period of time a specified amount of commodity or a specified futures contract at a specified price in accordance with the business rules or practices of an Exchange or a futures market at which the transaction is made."[92]

In other words, an option is a contract between two parties whereby the buyer of the option is given the right, but not the obligation to buy or sell a specific amount of the underlying commodity, on or until a future date, at a price agreed at the time of contracting. This price is known as the exercise price. For the exclusive rights conferred by the option, the buyer provides consideration in the

[92] See s. 2, FTA.

form of the payment of a premium to the seller. The seller of the option retains the premium whether or not the option is exercised.

Options on futures contracts are traded on SIMEX.[93] However, unlike trading futures contracts where there is equal risk for both buyer and seller, the nature of the risk exposure on a futures options position is different for the buyer and the seller of the option. The buyer of the option need only pay the cash premium, so that if he decides to allow the option to expire, he can lose no more than that amount. On the other hand, the seller of an option assumes a heftier financial exposure. The seller's possible loss is the total difference between the spot price for the futures contract and the exercise price, less the premium received.

The incentive to sell options is the ability to earn the premium;[94] however, the risk taken by a seller of options, as mentioned above, may be gargantuan. A potential customer of a futures broker is warned of this in a risk disclosure statement[95] which reads: "Selling ('writing' or 'granting') an option generally entails considerably greater risk than purchasing options. Although the premium received by the seller is fixed, the seller may sustain a loss well in excess of the amount of premium received."[96]

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[93] Options are available for JGB, Euroyen, Eurodollar, Nikkei 225 and Nikkei 300 futures.

[94] Selling options was Nick Leeson's undoing. "The reason why the losses grew was that I had to sell unhedged positions to bring in a decent premium," wrote Leeson and Whitley, *Rogue Trader*. Also see para. 3.34, Ministry of Finance's *Report*.

[95] See "Risk Disclosure Statement" at Chapter 6 below.

[96] See Form 12, Second Schedule, Futures Trading Regulations, as amended by the Futures Trading (Amendment) Regulations 1996, S 81/96, made on 15 February 1996. The previous unamended Form 12 had not provided a similar warning. The amendments embodied by Futures

6. Leveraged Foreign Exchange Trading

The 1995 amendments to the FTA brought leveraged foreign exchange trading, previously an unregulated activity, under the supervision of the MAS. Those who engage in leveraged foreign exchange trading are now subjected to licensing requirements similar to those who engage in financial futures trading. Prior to the 1995 amendments, there had been a number of "forex bucket shops" doing business in Singapore. Several had been raided by the Commercial Affairs Department, and investigated for various scams.[97] Dr Hu explained at the Second Reading of the Futures Trading (Amendment) Bill in 1995:

> "Currently, leveraged foreign exchange trading is not subject to any regulation. Any person can incorporate a company and offer such facilities to members of the public. The result has been a proliferation of such firms which use aggressive marketing and promises of high investment returns to entice unwary members of the public to trade in the foreign exchange market. MAS has received many complaints from customers on losses incurred in trading through such firms...Since leveraged foreign exchange trading and futures trading are similar in nature, leveraged foreign exchange trading can and should be regulated under the Futures Trading Act."[98]

Trading (Amendment) Regulations 1996, S 81/96 were the first in a series of amendments to the Futures Trading Regulations spurred by the Barings crisis.

[97] "Forex 'bucket shops' flee S'pore in the face of tighter controls," *The Straits Times*, 25 August 1995.

[98] Dr Hu, Minister of Finance, Singapore Parliamentary Debates, vol. 64 at col. 45 (1 March 1995).

As a result of the 1995 amendments to the FTA and the imposition of licensing requirements on these leveraged forex trading outfits, they have all ceased trading and none have applied for a licence.[99] It is obvious that these small outfits could not possibly have complied with the financial requirements stipulated in the FTA and the FTR. Brokerages which are not members of SIMEX must have a minimum paid-up capital of $8 million.[100] The effect of the 1995 amendments is such that leveraged foreign exchange trading by small firms has been wiped out.

There is a lengthy definition of "leveraged foreign exchange trading" in s. 2A(1)[101] of the FTA, but the legislature provided a pithy one in its Explanatory Statement to the Futures Trading (Amendment) Bill where "leveraged foreign exchange trading" was summarized to mean:

> "dealing in foreign exchange in the over-the-counter market on a margin basis, and includes the provision of any advance, credit facility or loan, or

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[99] See note 97, *supra*.

[100] See reg. 11A(1)(c). In the case of a brokerages who are members of SIMEX, the requirement under reg. 11A(1)(b) is a minimum paid-up capital of $5 million.

[101] Section s. 24A(1) defines "leveraged foreign exchange trading" as:

"(a) the act of entering into or offering to enter into, or inducing or attempting to induce a person to enter into or offer to enter into, a contract or arrangement on a margin basis (other than a contract or an arrangement that is made on an Exchange or a futures market) whereby a person undertakes as determined by the terms and conditions of the contract or arrangement --

(i) to make an adjustment between himself and another person according to whether a currency is worth more or less, as the case may be, in relation to another currency;

(ii) to pay an amount of money determined or to be determined by reference to the change in value of a currency in relation to another currency; or

(iii) to deliver to another person at an agreed future time and agreed amount of currency at an agreed price;

(b) the provision by any person referred to in paragraph (a) of any advance, credit facility or loan, whether directly or indirectly, to facilitate an act of the description referred to in that paragraph; or

(c) the act of entering into or offering to enter into, or inducing or attempting to induce a person to enter into, an arrangement with another person (whether on a discretionary basis or otherwise) to enter into any contract to facilitate an act of the description mentioned in paragraph (a) or (b)."

the management of customer's funds on a discretionary basis, for dealing in foreign exchange."[102]

The legislature further made it clear that the definition did not include a contract or arrangement made on SIMEX or a "futures market."[103]

The economics of leveraged transactions and futures transactions are very similar. In both cases, a person agrees to purchase or sell a certain currency at a future date, and places at the beginning of the transaction an amount of margin with the dealer to cover potential losses. However, the main differences between leveraged transactions and futures transactions are that leveraged transactions do not take place on a centralized market place or exchange. Furthermore, leveraged foreign exchange contracts are of unfixed duration and may have varying terms dealing with quantities and delivery plans of the underlying currency. These two differences would pose serious difficulties when attempting to squeeze leveraged foreign exchange transactions into the definition of a "futures contract" as provided in the FTA. The 1995 amendments made it clear that the concept of "leveraged foreign exchange trading" did not have to be linked to that of a futures contract or a futures market as defined in the FTA.

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[102] See Government Gazette Bills Supplement, no. 9 (24 January 1995) at 44.
[103] See *ibid.*

CHAPTER 4

THE INSTITUTIONS

1. The MAS

The FTA places SIMEX under the purview and supervision of the MAS. The MAS is Singapore's *de facto* central bank. It performs all the functions of a central bank except that of issuing currency which is done by the Board of Commissioners of Currency. The MAS is a statutory board and was established under the Monetary Authority of Singapore Act[1] in 1970. The MAS is controlled by the Singapore Government and its Board of Directors is chaired by the Minister of Finance.[2] .

One of the principal objects of the MAS is "to promote, within the context of the general economic policy of the Government, monetary stability and credit and exchange conditions conducive to the growth of the economy."[3] Apart from the supervision of the futures industry, the MAS also governs various other areas of the finance industry, including banks,[4] insurance companies,[5] financial institutions[6] and the securities industry.[7]

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[1] Cap. 186, Statutes of Singapore.
[2] For an introduction to the MAS, see generally Chapter 16, Tan Chwee Huat, *Financial Markets and Institutions in Singapore*, 8th edition, 1996, Singapore University Press.
[3] See s. 4(b), Monetary Authority of Singapore Act.
[4] See Banking Act, Cap. 19, Statutes of Singapore.
[5] See Insurance Act, Cap. 142, Statutes of Singapore.
[6] See Finance Companies Act, Cap. 108, Statutes of Singapore.
[7] See Securities Industry Act, Cap. 289, Statutes of Singapore.

Licensing Regime

The mainstay of the MAS's regulatory regime is the licensing of the various market participants in the futures market. It is a most effective power and one of the many powers in the MAS's arsenal aimed at the supervision of the futures market in Singapore. By controlling the licensing of market participants, the MAS controls entry into the futures business. Corporations and individuals who seek to enter the futures business have to apply for the appropriate licences from the MAS under either s. 11 or s. 12 of the FTA.[8] The MAS shall not refuse to grant or renew a licence without first giving the applicant an opportunity of being heard.[9]

The criteria established by the FTA upon which the MAS can refuse to grant or renew licences is set out in s. 14(1) of the FTA.[10] The 1995 amendments widened the original criteria to include more qualitative criteria such as the applicant's educational qualifications or experience, past performance or expertise in the futures business, financial standing, whether the applicant is "fit and proper" and whether it is in the interests of the public so to grant or renew a licence. The MAS has powers to impose conditions or restrictions on the licences issued.[11]

Concomitant with the power to grant licences is the power to revoke them. S. 20 of the FTA provides that a licensee may have its licence revoked on any

[8] See generally Part III, FTA and "Market Entry Requirements" at Chapter 5 below.
[9] See s. 13(3), FTA.
[10] For a full discussion of the criteria in s. 14(1), FTA, see "Market Entry Requirements" at Chapter 5 below.
[11] See s. 15, FTA.

ground on which the MAS may refuse a licence under s. 14(1) of the FTA, as well as, *inter alia,* insolvency in the case of a corporation, the failure or cessation of business for which the licence was granted, contravention or non-compliance with a restriction or condition of the licence, and "if the Authority has reason to believe that the licensed person has not performed his duties efficiently, honestly or fairly."[12] The MAS would rely on information provided by the licensee under its obligations under the FTA, by auditors where the licensee is a corporation and also by information provided to it by the public.

Disenchanted members of the public who make complaints to the MAS may initiate an inquiry procedure provided for in the FTA. This may lead to serious consequences for the licensee. It appears that anyone may make allegations of misconduct against a licensed person to the MAS. S. 21 of the FTA provides that the MAS "may inquire into any allegation that a licensed person is or has been guilty of any misconduct or is no longer a fit and proper person to continue to remain licensed by reason of any other circumstances which have led, or are likely to lead, to the improper conduct of business by him or to reflect discredit on the method of conducting his business."[13] Misconduct for the purposes of s. 21 means (a) any failure to comply with requirements of the FTA, and (b) any act or omission relating to the conduct of business "which is or is likely to be prejudicial to the public interest."[14] However, if the MAS finds that such an allegation was

[12] See s. 20(2)(a), FTA in the case of a licensed person who is an individual and s. 20(2)(b), FTA in the case of a corporation.
[13] See s. 21(1), *ibid.*
[14] See s. 21(5), *ibid.*

made in bad faith or was otherwise frivolous or vexatious, the complainant may be ordered to pay costs and expenses involved in the inquiry of the allegation.[15]

The procedure for the inquiry is not spelt out in the FTA save that at the hearing of the MAS inquiry, the licensed person is given an opportunity of being heard.[16] If the allegation of misconduct is proved after the inquiry, the MAS may if it thinks fit: (a) revoke the licence, (b) suspend the licence for such period, or until the happening of such event, as the MAS may determine, or (c) reprimand the person.[17]

Where the MAS refuses to grant or renew a licence under s. 14, revokes a licence under s. 20, or otherwise revokes, suspends a licence or reprimands a person under s. 21, s. 23 of the FTA provides that "any person who is aggrieved by the decision of the Authority may, within one month after he is notified of the decision, appeal to the Minister[18] whose decision shall be final." The FTA does not provide for appeal to a court.

The lack of recourse past the Minister and the use of qualitative criteria in deciding whether a licence should be granted caused concerned questioning in Parliament during the Second Reading of the Futures Trading Bill in 1986 where

[15] See s. 21(4), *ibid*
[16] See s. 21(3), *ibid.*
[17] See s. 21(2), *ibid.*
[18] This means the Minister of Finance, see Interpretation Act, Cap. 1, 1985 Ed., Statutes of Singapore.

one Member of Parliament warned against the "arbitrary exercise of powers by the MAS."[19] Dr Hu replied:

> "On the issue of appeal on the revocation of licences, this is a problem which has been levelled against the Government's other Bills in the past where it is considered rather unfortunate that there is no appeal past the Minister. The reason for this is, of course, that if we allow complete appeal on all licences to be taken to the courts,[20] we would probably have to increase our courts many more times than there are now. I also believe that in the issue of a licence for a particular trading activity, it is not a constitutional right for anyone to have appeal to the courts. It is a privilege which the Government grants at its pleasure in order to ensure that the proper people are engaged in these activities."[21]

The provision which states that the decision of the Minister shall be final does not necessarily rule out judicial review.[22] A similar provision in the Securities Industry Act stipulating that a decision of a Minister is final has been interpreted to be subject to judicial review. For judicial review to be successful, however, it has to be shown that the Minister has exercised his discretion and refused or revoked a licence, illegally, irrationally or with procedural impropriety. This is no easy task.

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[19] See the questions raised by Dr Augustine H. H. Tan at the Second Reading of the Futures Trading Bill, Singapore Parliamentary Debates, vol. 47 at col. 1437 (31 March 1986).

[20] The FTA clearly provides that no suit or other legal proceedings shall lie against the MAS, its officers and employees for any act done in performance of its duties or powers under the FTA or the FTR, or for any neglect or default in performance of such duties or powers, provided that the performance of such duties or powers were in "good faith". See s. 63, FTA.

[21] Singapore Parliamentary Debates, vol. 47 at col. 1439 (31 March 1986).

[22] This is the view of Walter Woon with regard to a similar s. 39 of the Securities Industry Act. See Laws of Singapore, Annotated Securities Industry Act, Butterworths. See generally *Anisminic Ltd v. Foreign Compensation Commission* [1969] 2 AC 147, *South-East Asia Fire Bricks Sdn Bhd v. Non-Metallic Mineral Products Manufacturing Employees' Union* [1980] 2 MLJ 165 and *Re Racal Communications Ltd* [1980] 3 WLR 181. As to the principles on which judicial review will be exercised in Singapore, see *Chng Suan Tze v. Minister of Home Affairs* [1988] SLR 132.

The inclusion of more qualitative and subjective criteria, by the 1995 amendments,[23] on the basis of which licences may be refused or revoked raised further concern. During the Second Reading of the Futures Trading (Amendment) Bill in 1995, Dr Hu assured:

> "...when licences are refused by the MAS...the person involved will have a hearing. He will. In fact, if he is dissatisfied with the rejection, he can apply for a hearing and he will be told what are the reasons for the rejection."[24]

Although not provided in the FTA, the Minister's comments appear to give a legitimate expectation to applicants that reasons for rejection will be provided. How detailed such reasons must be is an open issue.

Approval of Futures Exchange and Clearing House

MAS approval is required for the maintenance and the establishment of a futures market[25] or a clearing house[26] in Singapore. Wide ranging discretion is provided for in the exercise of the MAS's powers to approve a futures exchange or a clearing house. Approval will only be granted if *inter alia* "the interests of the

[23] The amendments are listed and discussed in "Market Entry Requirements" at Chapter 5 below.
[24] Singapore Parliamentary Debates, vol. 64 at col. 58 (1 March 1995). This statement was made in response to a question proposed by Dr Ow Chin Hock at col. 53: "...some criteria appear to be subjective. May I ask the Minister whether MAS will give the reasons of rejection to an applicant so that he can make up for his shortcomings?"
[25] See s. 3, *ibid*
[26] See s. 7, *ibid.*

public will be served".[27] Incidentally, SIMEX was not approved by the MAS either as a futures market or a clearing house. The FTA provides that no approval of the MAS is required for the futures market or the clearing house of a futures market established and maintained by SIMEX, but SIMEX is subject to all other provisions of the FTA.[28]

It seems unlikely in the near future that an entity would seek approval as a futures exchange in Singapore. A futures exchange is essentially a commercial venture and it is doubtful that the financial market of Singapore is capable of supporting more than one futures exchange. Nevertheless, upon such an application being made, the FTA provides that the MAS shall not refuse to approve a body corporate as a futures exchange without giving the applicant an opportunity to be heard.[29] Oddly enough, the FTA does not stipulate the same opportunity to be heard for a body corporate seeking approval as a clearing house.[30]

Approval of Futures Contracts

The MAS effectively controls the extent and scope of the futures business, as any contracts proposed to be listed by SIMEX have to be approved by the

[27] See s. 4(2)(b) and s. 8(2)(b), *ibid.*
[28] See s. 3(4) and 7(2), *ibid.*
[29] See s. 4(3), *ibid.*
[30] There appears to be inconsistent treatment of futures exchanges and clearing houses insofar as approval and revocation of such approval is concerned. The approval of a body corporate as a futures exchange may be revoked on various grounds set out in s. 6(1) of the FTA including the ground that the body corporate is "operating in a manner detrimental to the public interest". Any person aggrieved by a decision of the MAS to revoke an approval may appeal to the Minister whose decision shall be final and shall not be called into question in any court. See s. 6(3), *ibid.* Oddly yet again, revocation of approval as a clearing house is not provided for in the FTA.

MAS.[31] This provision was introduced by the 1995 amendments and surprisingly lacking in the original bill.

The FTA does not stipulate what considerations would be taken into account by the MAS with regard to the approval of contracts to be listed on SIMEX. It is recognized that the commercial interests of a futures exchange may not necessarily sit well with monetary stability and a cautious monetary policy. It is telling that the possibility and feasibility of trading a futures contract based on a local stock index has been mooted for some time[32] and that the profitability of such a contract to SIMEX is not inconsequential. However, although it is a matter of debate whether trading in stock index futures affects the price of the underlying stocks and therefore promotes volatility, the vulnerability of the Singapore stock exchange and the Singapore dollar are necessarily factors to be taken into account when authorizing such a futures contract. It is generally understood that the MAS adopts a conservative approach towards the Singapore dollar.

Supervision of SIMEX

One of the key functions of the MAS under the FTA is the supervision of SIMEX as a futures exchange and a clearing house. The MAS has broad powers and the FTA does not provide for the review of any MAS decisions made in

[31] See s. 4A, *ibid*.
[32] See "A Stock Index Future For Singapore," BC Ghosh and Abul Faizie, *SES Journal*, March 1993 at 22. SIMEX currently trades futures contracts based on the MCSI Hong Kong Index, the Nikkei 225 Stock Index and the Nikkei 300 Stock Index.

respect of SIMEX.[33] As mentioned earlier, MAS approval is required for the listing and de-listing of any futures contracts on SIMEX. It is also required for the operation of any electronic trading facilities.[34] Approval may be granted subject to such conditions as the MAS may think fit.[35]

Furthermore, the making of any amendments to the business rules or Rules of SIMEX requires the approval of the MAS.[36] On top of the power of the MAS to disallow the whole or part of an amendment submitted by SIMEX whereupon the whole or part of the amendment ceases to have force and effect, the MAS is given the power to alter or supplement the Rules, or to alter or supplement the terms and conditions of any futures contract traded on SIMEX, by its own motion, "if it considers such action is necessary for the protection of traders or to ensure fair dealing in a futures market."[37] The wording of this statutory provision is odd. It refers to the "protection of traders" without the slightest hint as to who a "trader" might be. If "traders" are, as in industry parlance, market participants who execute trades on the floor of the exchange either for their own account or for the account of another, it is odd that their interests should be put over and above the "interests of the public," or indeed, the interests of *all* the members of SIMEX.

[33] Where approval for a futures exchange granted under s. 4 of the FTA is revoked, the aggrieved party may appeal to the Minister pursuant to s. 6(3) of the FTA. See notes 18 and 22, *supra*. However, SIMEX was not approved pursuant to s. 4, and s. 6(3) would consequently not apply.
[34] See s. 4A(1), *ibid.* S. 4A was added to the FTA by the 1995 amendments.
[35] See s. 4A(2), *ibid.*
[36] See s. 5, *ibid.* The procedure for approval set out in s. 5 of the FTA begins with SIMEX giving written notice stating the text and date of the amendment as well as an explanation of the purpose of the amendment to the MAS. If such a notice is not given within 10 days of the making of the amendment, the amendment ceases to have effect. Within 28 days of the MAS receiving such notice from SIMEX, the MAS may disallow the whole or parts of the amendment. If this is so, the whole or that part of the amendment disallowed ceases to have effect.
[37] See s. 5(4), FTA.

Effective supervision of SIMEX would necessarily consist of the power of reviewing SIMEX's internal disciplinary procedure. Where SIMEX has taken disciplinary action against a member, it is required to notify the MAS.[38] The MAS may then review the disciplinary action and may affirm, modify or set aside SIMEX's decision after giving the member concerned and SIMEX an opportunity to be heard.[39]

Perhaps more importantly, where SIMEX fails to act against a member, the MAS has the power to itself suspend, expel or otherwise discipline a member of the SIMEX.[40] Before doing so, the MAS shall give the member concerned and SIMEX an opportunity to be heard.[41] Anyone aggrieved by the decision of the MAS may appeal to the Minister[42] whose decision shall be final.[43] However, this provision does not exclude the possibility of judicial review.[44]

Emergency Powers

Another dimension of regulatory control exercised by the MAS focuses not on entry into the futures market but on the operation or performance of futures markets. As mentioned, the economic functions of a futures market is to provide a forum for hedging risk and price discovery. Any practices that interfere with the efficient transfer of unwanted risk or with the process of price discovery would

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[38] See s. 46(1), *ibid.* See *Internal Disciplinary Procedures* in "SIMEX as Clearing House" below.
[39] See s. 46(2), *ibid.*
[40] See s. 46(3), *ibid.*
[41] See *ibid.*
[42] See note 18, *supra.*
[43] See s. 46(4), *ibid.*
[44] See the cases mentioned in note 22, *supra.*

stifle the futures market, and the trading of futures would be an exercise suitable only for speculative purposes. As such, the MAS has extensive powers under the FTA to stifle such malpractices. In particular it can conduct market surveillance and routine inspections of SIMEX and other licensed futures market participants,[45] and is given certain emergency powers to take remedial action in the event of an "emergency."[46]

These emergency powers are extraordinarily extensive and are not replicated in any other context, in particular, the MAS's supervision of the securities and the stock exchange under the Securities Industry Act. Whenever the MAS has reason to believe an emergency exists, it may direct SIMEX to take such action as MAS considers necessary to maintain or restore orderly trading in, or liquidation, of any futures contracts. Such action includes terminating or suspending trading on SIMEX,[47] confining trading to the liquidation of contracts,[48] ordering the liquidation of all or some positions,[49] limiting trading to a specific price range,[50] modifying trading days or hours,[51] fixing the settlement price at which contracts are to be liquidated,[52] requiring additional margins for any contracts,[53] modifying or suspending any of the Rules,[54] and the wide and cryptic

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[45] See s. 48, *ibid*
[46] See s. 41, *ibid.*
[47] See s. 41(1)(a), *ibid.*
[48] See s. 41(1)(b), *ibid.*
[49] See s. 41(1)(c), *ibid.*
[50] See s. 41(1)(d), *ibid.*
[51] See s. 41(1)(e), *ibid.*
[52] See s. 41(1)(g), *ibid.*
[53] See s. 41(1)(i), *ibid.*
[54] See s. 41(1)(j), *ibid.*

action of "requiring any person to act in a specified manner in relation to trading in futures contracts."[55]

An "emergency" is defined as including:

> "...in addition to threatened or actual market manipulations and corners, any act of government affecting a commodity or any other major market disturbance which prevents the market from accurately reflecting the forces of supply and demand for such commodity or any other undesirable situations or practices which in the opinion of the Authority constitutes an emergency."[56]

Drastic emergency action such as suspending trading on SIMEX is to be cautiously taken. The success of a futures exchange thrives on investor confidence. Investor confidence will necessarily rest in a predictable and reliable exchange that is prone to the least disruptions and government interference. SIMEX, as will be discussed, has emergency powers of its own.

2. SIMEX as Exchange

SIMEX is not Singapore's only futures exchange,[57] but it is the only one on which financial futures are traded. SIMEX is a public company limited by shares incorporated under the Companies Act[58] and whose shares are owned by its

[55] See s. 41(1)(h), *ibid*.
[56] See s. 41(3), *ibid*.
[57] As mentioned earlier in "FTA and CEA" at Chapter 3 above, SICOM trades in rubber and coffee futures. See Chapter 3, notes 6 and 7, *supra*.
[58] Cap. 50, Statutes of Singapore.

Clearing Members. Apart from Clearing Members, there are 3 other categories of non-shareholding SIMEX membership.[59]

SIMEX's Memorandum and Articles of Association[60] (the "Articles") clearly bind SIMEX and its Clearing Members, and its Clearing Members *inter se* under the companies legislation[61] and the corresponding principle in company law of common law origin.[62] SIMEX is empowered under its Articles[63] to make rules which provide for other categories of membership and codify the manner in which SIMEX, its Clearing Members and its other members conduct their affairs. The Articles provide that the resultant code or the Rules shall be binding upon SIMEX, the Clearing Members and all other classes of members.[64]

The Rules were completely revised in 1990 and contain 34 chapters of which 22 chapters contain the description and trading terms of the various contracts traded on SIMEX. The main body of the Rules set out, *inter alia*, the categories of membership, the procedures for enforcing the Rules, trading floor practices, arbitration procedures, the clearing house, margin and settlement

[59] The various categories of membership and the differing levels of rights and duties are discussed below in "Market Entry Requirements" in Chapter 5 below. Article 2.02 (a) of SIMEX's Articles of Association states that "The Exchange may have other classes of membership as from time to time may be provided in the Rules, provided however that membership of any such class shall not confer on such member any right to receive notices of any General Meetings required to be given under these Articles, to attend thereat or to vote thereat or to participate in the assets or profits of the Exchange." The Articles referred to are the Articles of Association of SIMEX dated 22 December 1983.
[60] The Articles referred to are the Articles of Association of SIMEX dated 22 December 1983.
[61] In particular, see s. 39, Companies Act.
[62] Stirling J in *Wood v. Odessa Waterworks Co* (1889) 42 Ch D 636 said "The articles of association constitute a contract not merely between the shareholders and the company, but between each individual shareholder and every other." See also *Salmon v. Quin & Axtens Ltd* [1909] 1 Ch 311.
[63] See Articles 14.01 to 14.03.
[64] See Article 14.03.

mechanism, the duties of the various categories of members and the mutual offset system.

The Rules may and are often amended from time to time.[65] The Articles provide that the Rules shall be made, altered or repealed by a resolution of the Board of Directors of SIMEX who shall adopt such means as it deems sufficient to bring the same to the notice of the Clearing Members and the other classes of members.[66] As a matter of practice, SIMEX issues circulars to its members notifying them of possible changes to the Rules, and, in certain cases, circulars to clarify the interpretation and implementation of the Rules. Any amendment of the Rules, however, requires the approval of the MAS under the FTA.[67] The Rules, of course, have to comply with the requirements of the FTA and the FTR.

SIMEX's *raison d'etre* as such is the running and maintenance of a physical marketplace where financial futures trading is centralized, being modelled on the CME. SIMEX provides the physical location and facilities for its members to engage in financial futures trading. Over and above the provision of a physical exchange for such trading, SIMEX maintains and operates the clearing house which is essential to a smoothrunning futures marketplace as it eliminates counterparty risk.[68]

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[65] See Article 14.01.
[66] See Article 14.02.
[67] See s. 5, FTA. See *Supervision of SIMEX* in "The MAS" above.
[68] See "Organized Exchanges" at Chapter 2 above.

The clearing house is established for the purposes of "facilitating the prompt adjustment of contractual obligations arising out of contracts" concluded on the exchange and to "protect the integrity of such contracts".[69] In practical terms, the clearing house manages the margin system and ensures contract performance by guaranteeing all contracts.[70] In Singapore, the clearing house is an association or organization of SIMEX Clearing Members. It is not incorporated separately and may be viewed as a department within SIMEX.

As a commercial exchange and clearing house, SIMEX regulates itself by maintaining several departments with specific areas of responsibility regarding the monitoring of the conduct of business on the exchange. These departments oversee the day-to-day activities of the exchange and clearing house:

(a) an Audit and Review Department which monitors SIMEX members to ensure that they are financially sound as well as professional in their practice and dealings with customers. This is done by conducting regular audits of SIMEX members to check that the Rules and any further internal procedure requirements are complied with. One of the most important exercises done by this department is the liquidity assessment. The department is required to consider the liquidity positions of SIMEX's Clearing Members daily to assess their ability to meet calls made by the clearing house.[71]

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[69] See Article 5.01.
[70] This will be discussed further in "SIMEX as Clearing House" below.
[71] For further discussion of the Audit Review Department and its role in the Barings collapse, see the Ministry of Finance's *Report* at para. 15.14 to 15.29.

(b) a Trading Floor and Compliance Department which monitors trading floor practices to check for possible malpractices, as well as handles complaints and ensures that business is fairly conducted. In carrying out its duties, the department employs compliance officers to review the activities on the trading floor and to check for non-compliance with the Rules;[72] and

(c) a Market Surveillance Department which monitors market activity to ensure that no attempts are made to manipulate the market. This department also monitors the position limits and large positions of SIMEX members and their customers.[73]

Internal Disciplinary Procedures

Since SIMEX is a self-regulating exchange and clearing house with its own body of Rules and regulations, an internal disciplinary system maintains internal "law and order." Any breach of the Rules by a member would result in the commission of either a major offence or a minor offence.

Major offences are dealt with by expulsion, suspension, a fine not exceeding S$25,000 or by both suspension and a fine. Minor offences are dealt

[72] For further discussion of the Trading Floor and Compliance Department and its role in the Barings collapse, see *ibid* at para. 15.33 to 15.37.
[73] For further discussion of the Market Surveillance Department and its role in the Barings collapse, see *ibid* at para. 15.30 to 15.32.

with by a fine not exceeding S$5,000 or suspension for not more than one year, or both.[74] Particular Rules expressly state that their infringement would lead to the commission of a major offence.[75] Rule 415 further sets out a list of major offences. Similarly, Rule 416 sets out a list of minor offences but also states that the violation of any Rule, the violation of which is not a major offence, is a minor offence.

Upon a violation of the Rules, the matter may be dealt with by the President or by one of the Committees of SIMEX.[76] The various Committees presently provided for in the Rules which can conduct hearings into violations of the Rules are the Business Conduct Committee,[77] the Clearing House Committee,[78] the Floor Committee[79] and the Pit Committee.[80] Each Committee has a different hearing procedure and these are set out in the Rules.[81]

Only the Pit Committee has the capability of conducting "summary proceedings."[82] Each futures contract is traded in a designated pit. Each pit has a

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[74] See Rule 413.

[75] For instance, Rule 917 relating to segregation of customer's money, securities and property, Rule 520 relating to the priority of customers' orders and Rule 521 relating to trading against customers' orders. The violation of these rules would necessarily lead to violations of s. 37(1), s. 37A and s. 37B, FTA, respectively. The penalty stipulated in the FTA for these violations is a fine not exceeding $30,000 or imprisonment for a term not exceeding 3 years or both. See s. 40, FTA.

[76] See Rule 405. For the duties of the President, see Rule 401.

[77] See Rules 302 and 402.

[78] See Rules 303 and 403.

[79] See Rules 307 and 404.

[80] See Rules 309 and 404A.

[81] See Rules 408, 409, 410 and 410A.

[82] See Rules 309, 401, 404A and 410A.

Pit Committee. The Pit Committee has the jurisdiction to deal with basic "trading infractions" which are specified as:[83]

(a) a bid or offer which is out of line with the market;

(b) a bid or offer which tends to confuse the other traders;

(c) a sale which is out of line with existing bids or offers;

(d) failure to confirm a transaction;

(e) failure of buyer and seller to announce a change in the last sale price and failure to ensure that it is properly recorded;

(f) use of unbusinesslike language on the floor; and

(g) conduct which tends to distract or intimidate any SIMEX employee.

Hearings of the Pit Committee are conducted at the end of the business day and the matter decided upon by a majority of votes within the Pit Committee. The "trading infractions" are neither minor nor major offences. The Pit Committee may reprimand the concerned member, impose fines not exceeding S$1,000 or suspend the member for not more than five days or order the member's removal from the pit or a combination of any of the above penalties, save that a first-time offender or a member who has not been found guilty of a similar or related offence in the past year is not to be fined more than S$100.[84] There is no appeal against decisions of the Pit Committee which involve fines of S$500 or less.[85] Otherwise, appeals from

[83] See Rule 510.
[84] See *ibid.*
[85] See SIMEX Notice GEN/33 of 1986 (26 November 1986).

decisions of the Pit Committee are made to the Floor Committee whose decision shall be final.[86]

For other violations of the Rules, the matter may be dealt with by the President.[87] If the President is of the opinion that such violation may be best dealt with by either the Business Conduct Committee, the Clearing House Committee or the Floor Committee, he shall transmit to the chairman of the relevant committee a written statement setting forth the charges against the member involved and request that a hearing be held.[88] The jurisdiction of the Business Conduct Committee covers price manipulation and corners, and the general business conduct of members, including conduct affecting non-member customers.[89] The jurisdiction of the Clearing House Committee comprises the manner of clearing trades, the functioning of the clearing house, margin and financial integrity of clearing members and the general business conduct of members, save for manipulations and corners.[90] The jurisdiction of the Floor Committee is to supervise all matters relating generally to trading practices.[91]

Each Committee has a range of disciplinary action available to them, ranging from ordering the member to cease and desist from the offending conduct to the imposition of a fine or suspension.[92] As mentioned earlier, the President may decide to deal with a matter himself. However, the Rules do not provide what

[86] See Rule 411. There is no appeal to the Board of Directors in this case.
[87] See Rule 405.
[88] See *ibid.*
[89] Insofar as jurisdiction over such conduct is not assigned to the other Committees, see Rule 402.
[90] Which are already assigned to the Business Conduct Committee, see Rule 403.
[91] Save for matters already assigned to the Pit Committee, see Rule 404.
[92] See Rules 408:A, 409:A and 410.

range of disciplinary action is available to him. It is provided though that after investigation, the President may, if there is reasonable cause to believe that the violation of the rule is of sufficient importance, send the matter directly to the Board of Directors (the "Board").[93] Similarly, if after a hearing by the Committee the majority of the Committee decides that the matter is of major importance or might warrant a disciplinary action in excess of its own authority, the chairman of the relevant Committee shall refer the matter to the Board for further hearings and decision.[94]

All hearings other than a hearing by the Pit Committees shall be preceded by a written notice to the member under investigation specifying the offence with which he is charged and the date and venue of such hearing.[95] The hearing body may require any member or member's employee to attend, to testify and to produce all books and records relevant to the subject matter under investigation.[96] Prior to the hearing, the member under investigation may examine all evidence which is to be relied upon during the hearing.[97] Formal rules of evidence are not applicable.[98]

Any person aggrieved by the decision of the President or any other Committee[99] may within ten days of any such decision appeal to the Board whose

[93] See Rule 405.
[94] See Rules 408:A, 409:A and 410.
[95] See Rule 406.
[96] See *ibid.*
[97] See *ibid.*
[98] See *ibid.*
[99] Other than a decision of the Pit Committee or any appeal from a decision of the Pit Committee. See Rule 411 and note 86, *supra*.

decision shall be final unless the member can show that the disciplinary action taken was the result of false testimony, was too severe, or was otherwise improper, in which case, the member may petition for a rehearing by the Board.[100]

Since SIMEX, albeit an essentially a private body and a company incorporated under the Companies Act, is regulated by the FTA and subject to its governance and authority, it has an element of public flavour superimposed upon it. The Rules themselves require MAS approval. Furthermore, the SIMEX Board and Committees have the authority to determine the rights of persons licensed under the FTA.

As such, it could be argued that in purporting to exercise its disciplinary functions, SIMEX has the duty to act judicially in the exercise of that power and is therefore subject to judicial review. This was the gist of the Malaysian court's argument in *O.S.K. & Partners Sdn. v. Tengku Noone Aziz*[101] wherein it was held that the Kuala Lumpur Stock Exchange was such a quasi-public body subject to judicial review. In *Stock Exchange of Hong Kong Ltd v. Onshine Securities,*[102] it

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[100] See Rules 411 and 412.

[101] [1983]1 MLJ 179. See note 22, *supra* for cases dealing with the principles of judicial review. In *Ganda Oil Industries Sdn Bhd v. Kuala Lumpur Commodity Exchange* [1988] 1 MLJ 174, it was held that the decision by the Kuala Lumpur Commodity Exchange ("KLCE") which fixed the price of a commodity under the exercise of a power expressly provided for in their business rules was not and should not have been made amenable to judicial review. However, in the *Ganda Oil* case, the court made it clear that it was not deciding in general whether the KLCE is a public body whose decisions are subject to judicial review. In respect of an exchange's disciplinary proceedings against members, it is submitted that the *O.S.K.* case is more to point.

[102] [1994] 1 HKC 319. However, it was held that where an alternative remedy is available, in this case, an internal disciplinary appeal committee, a party subject to disciplinary proceedings should normally be left to pursue that remedy, and that judicial review in such a case should only be granted in exceptional circumstances.

was assumed that the disciplinary proceedings of the Stock Exchange of Hong Kong should be subject to judicial review.

Inter-Member Arbitration

Neither the FTA nor the FTR requires SIMEX to adopt a compulsory inter-member arbitration regime. However, a speedy inter-member dispute resolution mechanism is a bonus to any fast-paced futures market sensitive to disruptions. SIMEX provides such a mechanism, though it is unclear whether it is compulsory.

There is no Rule which states categorically that disputes between members must be arbitrated.[103] Instead, Rule 600 provides:

> "The Exchange shall maintain a forum for the resolution of all disputes where such disputes involve a transaction on the Exchange..., relate to such transaction or otherwise relate to the Exchange..."[104]

The wording of Rule 600 is wide enough to catch all manner of disputes relating to SIMEX, including transactions actually undertaken on SIMEX or proposed transactions which did not come to fruition because of action or inaction that is the subject of dispute.

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[103] Indeed, Rule 827 alludes to the permission by SIMEX of litigation between members in respect of exchange disputes. Rule 827 deals with "give-up trades". See "Inter-Member Issues" in Chapter 5 below.

[104] Rule 600 extends to the resolution of all disputes where such disputes involve a transaction on other exchanges with which SIMEX has a mutual offset arrangement. This aspect will not be discussed in this paper.

Rule 600 continues to state that when any dispute occurs between members, it "shall be promptly reported" by the complainant. This would suggest that the pursuance of litigation in the courts without making such a report would be a breach of the Rules. Save for the word "promptly," the Rules are silent as to when such a report is to be made upon the occurrence of the dispute. However, the requirement to report a dispute promptly could be read as a limitation period. As a matter of interpretation, the period cannot be unreasonably short. However, in the context of a fast-moving futures market, it cannot be as long as the statutory limitation periods, for that would defeat the purpose of exchange arbitration. A clearer yardstick of time is difficult to formulate, nor is it required to be, for the wording presently provided in the Rule allows a certain amount of flexibility, and places SIMEX in a position to consider all the relevant facts and circumstances, including whether there was any unnecessary delay on the part of the complainant in making a report which delay could prejudice the accused member.

It is a corollary to the rule that a dispute needs be "promptly" reported to initiate the arbitration procedure that a complainant would forfeit his right to arbitration under if SIMEX considers the report not to be prompt. In such a case, the complainant would not be able to resort to a civil action in the courts as all SIMEX members are effectively bound contractually to comply with the Rules. This would, of course, not prevent the complainant party initiating legal action, but this could be struck out by the defendant party on the basis that it discloses no cause of action.

Upon the complainant or the party requesting an arbitration reporting the dispute "promptly" to the President, the President then determines whether the dispute shall be arbitrated and informs the parties in writing.[105] At this point, it is possible that if the President makes a determination that the dispute is not to be arbitrated or remains silent, a civil action may be pursued.[106]

If the dispute is to be arbitrated, the parties are given a form of arbitration agreement for their signatures. The so-called accused, upon receiving notice from the President of the matter to be arbitrated has 10 days to file an appeal in writing with the Board stating reasons for refusing to arbitrate. The Board would then hear the appeal, and after the hearing, either reverse or affirm the ruling of the President. Any member of SIMEX who refuses to arbitrate after an initial ruling by the President or after an unsuccessful appeal to the Board, is guilty of a major offence pursuant to the Rules.[107]

As mentioned earlier, it is desirable that inter-member disputes on futures exchanges should be resolved quickly and efficiently. The Rules provide that upon the execution of an arbitration agreement between the parties, the President refers the matter for arbitration and the matter is heard within 10 days of such referral.[108]

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[105] Rule 600 states that the President shall determine whether the dispute shall be arbitrated or resolved by another committee (presumably other than the Business Conduct Committee which conducts arbitrations) or by the Board. Where the President determines that the dispute be resolved otherwise than by arbitration, it is unclear whether the complainant member may pursue the matter by litigation.

[106] This could be the conceivable occasion whereby litigation is permitted, as contemplated by Rule 827. See discussion on *Give-Up Trades*, "Inter-Member Issues" at Chapter 5 below.

[107] See Rule 415 and *Internal Disciplinary Procedures* above.

[108] See Rule 603.

Inter-member arbitrations are heard by the Business Conduct Committee.[109] Legal representation is not specifically disallowed. Rule 604 which governs the conduct of hearings provides that as far as defences are concerned, the so-called defendant can make any defence which would be available to him in a court of law. It goes on to say that the defendant member may "make a counterclaim arising out of the transaction that is the subject of the original claim" and counterclaims "which do not arise out of the transaction that is the subject of the original claim" may be heard only if the complainant agrees. The wording here is somewhat confusing as a "counterclaim", in legal parlance, is a cross-action which has a separate and independent standing unlike a "set-off" which is a cross-action in the nature of a defence. Where the set-off is for damages, it must arise out of the same transaction as the original claim or be closely connected with the subject matter of the original claim.[110] In practical terms, however, it is good practice to plead set-offs as counterclaims so that they would have a life of their own should the original claim fail and recovery of a counterclaim, but not a set-off, may be in excess of the original claim.[111] Rule 604 essentially provides that counterclaims in the nature of a set-off may be brought forward by the defendant member. However, counterclaims not in the nature of a set-off may only be brought forward if the complainant agrees. Counterclaims, as mentioned, can take on a life of their own should the complainant's own claim fail, and the recovery pursuant to a counterclaim may be in excess of the claimant's own claim. In such circumstances,

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[109] See *ibid*. Also see Rule 402 for the jurisdiction of the Business Conduct Committee.
[110] See Jeffrey Pinsler, *Civil Procedure*, 1994, Butterworths at 247.
[111] See *ibid* at 248.

it would be surprising if a claimant would agree to the hearing of a counterclaim which does not arise out of the subject of its own claim. This is particularly so if the dispute giving rise to the counterclaim was one that had not been "promptly" reported pursuant to Rule 600.

Like most arbitrations, those conducted by the Business Conduct Committee are not tied by the strict rules of evidence. The committee is at liberty to admit and consider any evidence whatsoever notwithstanding that it may not be admissible under the law.[112] The Rules provide that an arbitration award may only be appealed against where the amount in dispute exceeds S$5,000.[113] The dissatisfied party has to file a written notice with the President within 10 days from the date of award and the appeal is heard by the Board.

The Board may dismiss the award of the Business Conduct Committee on the following grounds:

(a) where the award was procured by corruption or fraud;

(b) where there was partiality on the part of the committee or any of its committee members;

(c) where the committee was wrong in refusing to hear relevant evidence or guilty of any other misconduct as a result of which the rights of any party have been prejudiced;

(d) where the committee exceeded their jurisdiction; and

(e) where the committee acted in manifest disregard of the applicable provisions of the Articles and the Rules.[114]

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[112] See Rule 604.
[113] See Rules 605 and 606.
[114] See Rule 607.

It would appear that these grounds are exhaustive. It is interesting to query what the phrase "exceeded their jurisdiction" could mean. The Business Conduct Committee's jurisdiction as expressed in the Rules embraces generally the conduct of arbitrations.[115] It is more likely that the phrase "exceeded their jurisdiction" be interpreted, in the spirit of commercial arbitration, to mean that the committee, as arbitrators, had decided wrongly on a question of law, either as a result of not obtaining legal advice when it should have or having obtained wrong legal advice.[116]

SIMEX and Non-Members

The Rules provide that if the Business Conduct Committee has reason to believe or suspect that a non-member of SIMEX is conducting his trading activities in violation of the Rules, the Committee may give notice to such non-member and any members that handle or clear his trades to appear, produce documents and testify at a hearing.[117] The particular non-member who technically is not bound by the Rules may choose not to show up, however, commercial sanctions may be taken against him.

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[115] See Rule 402 states that the "Business Conduct Committee shall supervise the business conduct of Members, conduct investigations and hearings on those matters over which it has been assigned jurisdiction under the Rules and conduct arbitrations..."

[116] Rule 604 indeed provides that the committee "shall be the sole judge of the Articles, the Rules and the facts." By being the sole judge on questions of law, it has exceeded its jurisdiction. Rule 604 continues to state that "if the committee is in doubt in any question of law, it may refer the same to the legal advisers of the Exchange for their opinion." In the same respect, in making an award based on wrong legal advice, the committee is in excess of its jurisdiction.

[117] See Rule 408:C.

If, after the hearing, the Business Conduct Committee determines that the actions of the non-member threatens the integrity or liquidity of any contract or are likely to result in the manipulation of prices, the Committee may order the member clearing the trade to liquidate all or any portion of the non-member's position in the threatened contract. Alternatively, the Committee may order that no members are to accept new positions in the threatened contract on behalf of such non-member.[118] The Committee can only take steps against non-members in a limited manner with reference to a threatened contract. There is no route of appeal within SIMEX with regard to such a decision. A non-member who is aggrieved by the decision of the Committee may conceivably apply for judicial review on the basis that SIMEX is a quasi-public body whose disciplinary powers are subject to judicial review.[119] Hardly a practical course to take due to limited effect of the sanctions against the non-member.

Insofar as non-member complaints against a SIMEX member or their representatives are concerned, there is an arbitration procedure provided for. A non-member customer may submit for arbitration, within one year of the action giving rise to the claim where it arises out of a transaction upon SIMEX and where the claim does not exceed S$15,000.[120] This arbitration procedure is not compulsory and nothing in the Rules or the FTA prevents the non-member from resorting instead to civil action in the civil courts. Indeed, for claims exceeding S$15,000, resort to the courts is required.

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[118] See *ibid.*
[119] See *O.S.K. & Partners Sdn. v. Tengku Noone Aziz* [1983]1 MLJ 179 and note 101, *supra.*
[120] See Rule 408:D.

Customer claims for less than $5,000 may, "in the interests of efficiency and economy," be assigned for resolution by the President.[121] The President is to employ procedures designed to ensure that the costs of prosecuting the claim will commensurate with its value.[122] The decision of the President in the dispute is to be submitted to the Business Conduct Committee and would be deemed the decision of the Committee upon approval by the Committee. Such decision is final and no route of appeal is provided within SIMEX.

Failure to Enforce Rules

S. 9(1) of the FTA provides that:

> "Any person, who is aggrieved by the failure of an Exchange or a clearing house or any of the directors or employees of the Exchange or clearing house to enforce its business rules or in enforcing those business rules contravenes this Act or any regulations made thereunder, has a right of action in damages for the actual amount of damages suffered by that person in any transaction that he has entered into on or subject to the business rules of a futures market that is directly attributable to the failure to enforce, or in the enforcement of the business rules, in contravention of this Act or the regulations, as the case may be."

This recourse is available to both members and non-members of SIMEX. The aggrieved person in pursuing this action in damages against SIMEX either as

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[121] See *ibid.*
[122] See *ibid.*

exchange or clearing house, has to show that, in failing to take action or in taking such action that resulted in a loss to the aggrieved person, SIMEX, or any of its directors or employees had acted in *bad faith*.[123]

S. 9(3) expressly states that the right of action conferred by s. 9(1) is to be an exclusive remedy available to an aggrieved person.[124] This means that any other recourse in the civil courts under another cause of action, for example, a tortious claim, cannot be pursued if the fact scenario supports a s. 9 action. The aggrieved person, therefore, has no choice as to which cause of action to pursue, even though a tortious claim based on negligence is *prima facie* easier to establish on certain facts than an action under s. 9 where bad faith has to be established.

It is an open issue as to what bad faith entails, but it usually includes elements of malice.[125] It requires an investigation into SIMEX's intention in failing to enforce the Rules and a finding that such an intention was injudicial and wrong. This, conceivably, may be shown where there is bias or favour shown to a rule-breaking member which is inexplicable in terms of the exchange's overall policy and interest or the public interest.

123 See s. 9(2), FTA.
124 See s. 9(3), *ibid.*
125 The phrase "bad faith or malice" has been used in various pieces of legislation, eg Legal Profession Act, Cap. 161 at s. 106, Accountants Act, Cap. 2A at s. 63 and Architects Act, Cap. 12 at s. 38, in relation to the issue of when action may be taken against the relevant professional bodies for action done under the respective Acts.

Fidelity Fund

The 1995 amendments included provisions for the establishment of a fidelity fund by a futures exchange, namely SIMEX.[126] The fidelity fund is to consist of an amount of not less than S$5 million.[127] The fund is to be increased every year by an annual payment into the fund of a sum that is equal to 10% or more of the annual net income of SIMEX. The fidelity fund is to be applied "for the purpose of compensating any person, other than an accredited investor,[128] who suffers pecuniary loss because of a defalcation committed in the course of or in connection with the trading of a futures contract"[129] which was cleared or to be cleared on SIMEX by a SIMEX member, its director, officer, employee or licensed representative.

The defalcation is to be in relation to any money or property that was actually entrusted to or received by the defalcation. Since accredited investors are not allowed to make claims from the fidelity fund, this suggests that the fidelity fund is conceived to benefit the smaller or retail investor.[130] Bearing this in mind, the limits to claims stipulated in the fidelity fund provisions do not seem too ungenerous. The total amount that may be paid out of a fidelity fund to all persons

[126] See s. 49A, FTA
[127] See s. 49F(1), *ibid.* SIMEX was given six months after the commencement of the Futures Trading (Amendment) Act 1995 to comply, see s. 49F(3), *ibid.*
[128] See Chapter 3, notes 72 and 73, *supra*.
[129] See s. 49I(1), FTA.
[130] Dr Hu at the Second Reading of the Futures Trading (Amendment) Bill stated: "Because of the growing interest from retail investors to trade in SIMEX futures contracts, additional safeguards to protect their interests are needed. The Bill therefore requires SIMEX to establish a Fidelity Fund..." See Singapore Parliamentary Debates, vol. 64 at col. 46.

eligible to claim compensation and who suffer loss through defalcations by a member of SIMEX cannot exceed in respect of the defalcating member the sum of S$500,000.[131] Furthermore, the maximum amount payable to each claimant to satisfy any claim is not to exceed S$100,000 or 75% of the actual pecuniary loss suffered by the claimant.[132]

To make a claim, a person who has suffered the requisite pecuniary loss is to take proceedings in the High Court against SIMEX to establish the claim.[133] However, a person cannot commence such proceedings without the consent of SIMEX unless SIMEX has disallowed his claim *and* the claimant has exhausted all relevant rights of action and other legal remedies for recovery of the money or other property, in respect of which the defalcation was committed.[134] The exhaustion of all legal avenues is potentially a costly exercise. It is harsh to require a claimant to do so, and to show that such pursuits were futile or insufficient, before being able to commence proceedings against SIMEX to claim against the fidelity fund. This is particularly so in the case of a retail investor. However, it is only in cases where a claim is disallowed that the claimant has to resort to pursuing alternative forms of action against other parties and of pursuing SIMEX via the High Court. The reasonableness and propriety of SIMEX in meting out claims is a stalwart of the system and is presumed.

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131 See s. 49I(2), *ibid.*
132 See s. 49J(3), *ibid.*
133 See s. 49J(1), *ibid.*
134 See s. 49L(2), *ibid.*

Under the Rules, SIMEX itself is obliged to establish and maintain a trust fund specifically for the protection of the customers of its members.[135] The precise terms regarding the amount and contributions to the trust fund as well as claims therefrom are not found in the Rules, but in Board resolutions and directions. Therefore, at present, SIMEX members' customers can claim from one of two funds.[136] One is maintained by SIMEX under the FTA requirements and the other under the Rules.

3. SIMEX as Clearing House

Generally, the exchange is responsible for trading procedures and the overall supervision of its members. The entity which is fundamental to the financial operations and integrity of an exchange is the clearing house. As mentioned earlier, the clearing house with regards to SIMEX is an association or organization of SIMEX Clearing Members.

The SIMEX Clearing House is not incorporated separately[137] and may be viewed as a department within SIMEX. It is provided in the Articles that wherever any provisions of the Rules create a right in favour of the clearing house or impose a liability on the clearing house, such right or liability shall be construed as a right

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135 See Rule 915.

136 It is unlikely that double recovery would be tolerated.

137 Many exchanges including those in Hong Kong, New Zealand, Bermuda, Australia and Hong Kong have had their trades cleared by a clearing house which was a separate entity from the exchange. The International Commodities Clearing House Limited ("ICCH") is headquartered in London and since 1888 has provided clearing services. See generally Chapter 2, Carroll, *Financial Futures Trading*.

or liability of SIMEX and shall be enforced by or against SIMEX.[138] In a nutshell, any grievance against the clearing house is a grievance against SIMEX as a corporate entity and an approved futures exchange in Singapore.[139]

The importance and role of the clearing house has been succinctly articulated thus:

> "...it is the clearing house which effectively transforms what would otherwise be forward contracts into highly liquid futures contracts. Operationally, the clearing house is responsible for matching the purchase and sales transactions, guaranteeing performance under the terms of the futures contract and managing the delivery process. It administers the margin system and oversees the enforcement of solvency regulations which, enhanced by direct guarantees backed by its own capital and that of its members, provide financial integrity for the contracts. Its unique legal status as the "party to every trade" facilitates the transfer of funds among participants, promoting contract liquidity and allowing settlement by offset."[140]

The Process of Substitution

Those who have traded on SIMEX look to the SIMEX Clearing House for the performance of contracts and not to the other party of the trade. All contracts concluded on SIMEX are sent by Clearing Members for clearing by the Clearing

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[138] See Article 5.05.
[139] Rule 800 states *inter alia*: "Wherever the Rules create a right in favour of the Clearing House or impose a liability on the Clearing House, such right or liability shall be construed as the right or liability of the Exchange, and shall be enforced by or against the Exchange."
[140] Chapter 2, Carroll, *Financial Futures Trading* at 28

House.[141] Once cleared or registered by the Clearing House, the Clearing House becomes the seller to the buyer and the buyer to the seller. This phenomenon is known as "substitution" in the Rules.[142] In terms of legal analysis, the contractual notion of novation is perhaps the most appropriate to apply here.[143]

Once substitution or novation occurs, it is fairly clear that the Clearing House becomes the counterparty to two futures contracts, as buyer to one and seller to another, and takes over all the rights and obligations of the previous buyer Clearing Member and the seller Clearing Member. A successful substitution occurs when the Clearing House accepts what is termed the "clearing memoranda". The clearing memoranda is submitted by the Clearing Members and states the particular trades which have been entered into in a particular day. A comparison of clearing memoranda must indicate that the Clearing House is long to certain Clearing Members and short to others the identical amount of the same contract and at the same prices.[144] If clearing memoranda submitted by one Clearing Member does not match the memoranda submitted by the opposite Clearing Member, such clearing memoranda will be automatically rejected.[145] If and only if, after such comparison of clearing memoranda, the Clearing House accepts the clearing memoranda, the Clearing House shall be substituted as and shall assume the

[141] Rule 800 states *inter alia*: "All contracts traded on the Exchange shall be cleared through the Clearing House, which shall maintain a record of these transactions."
[142] See Rule 803.
[143] See David Yeow, "Singapore--Regulation of Futures and Options," *The Capital Guide to Financial Futures and Traded Options in Asia*, 1996, ISI Publications at 195 on the effect of registration of the contract by SIMEX: "The effect of registration is to discharge the original oral contract and replace it with two contracts. In this regard, the replacement is effected via the novation route. Upon the novation of such a trade, SIMEX would act as a seller to the original buyer on the flip side and it will be the buyer to the original seller."
[144] See *ibid.*
[145] See Rule 808:C

position of seller to the buyer and buyer to the seller, and shall have all the rights and be subject to all the liabilities with respect to such transaction of the Clearing Members who were the parties to such transactions.[146]

When trades are matched and the clearing procedures successfully completed, market participants would look to the Clearing House for the performance of their orders. The position is less clear when trades are not matched and are rejected by the Clearing House. In such a case, a dispute would arise between the two traders on either side of the purported execution of the order. An "out-trade" would have occurred.[147]

By acting as the party to every trade, a clearing house assumes the credit risk of the trading counterparties. This is an immense financial responsibility on the part of a clearing house and it thus requires its members to be of a certain financial calibre. The financial integrity of its clearing members is essential to the reliability and proper functioning of a clearing house system. This is ensured in Singapore by the stringent financial requirements required of the Clearing Members of SIMEX.[148]

In any case, assuming the credit risk of being substituted as the party to every trade completed on an exchange could be an overly onerous burden on the part of the clearing house if taken on without any safeguards. It is unlikely that

[146] See Rule 808 generally for an account of the clearing procedures.
[147] See Rule 808:D and "Inter-Member Issues" at Chapter 5 below.
[148] See "Market Entry Requirements" at Chapter 5 below.

clearing members would take on unlimited risk as a clearing house collective. Consequently, a two-tiered means of ensuring the financial integrity of market participants or those who trade on the exchange is utilized to contain the risk. First, before a contract is allowed to be executed on the exchange, the clearing house collects "margin". Second, a daily mark-to-market settlement system prevents losses by a single trader from chalking up.

Daily Settlement

When a futures trade has been done, prior to offset by cash settlement or delivery, the futures obligation remains open. All open positions on SIMEX are revalued on a daily basis, using SIMEX's end-of-day settlement prices. This is known as the "mark-to-market" system. It is not peculiar to SIMEX and is a distinct feature of futures exchanges. Losses are not allowed to accumulate for more than a day.

Depending on whether a futures contracts' price has risen or fallen, a Clearing Member suffers either a loss or a profit. If a loss is suffered, payment has to be made to the Clearing House. If there is a profit, payment is made by the Clearing House to the Clearing Member. All debts are settled daily.[149] The Clearing Member would then either debit or credit the account of its customer

[149] In practice, this process concerns only the settlement banks with whom the Clearing Members have accounts. Adjustments to the various accounts including that of the Clearing House is done by way of a settlement variation performed by the settlement banks. The settlement banks, upon completion of the procedure, would communicate to the Clearing House a confirmation that collections from all Clearing Member accounts have been made for amounts due as a result of the particular trading day's mark-to-market.

accordingly. As will be discussed, the relevant accounts contain margin deposits, made up of initial margin as well as variation margin.

The daily mark-to-market settlement procedure ensures that all obligations for new and existing positions are cleared before the start of each day's trading. Members may not trade until they have made good any deficit in their accounts. This limits the exposure of the Clearing House.

Margin Trading

Under the Rules, Clearing Members are required to place margin deposits with the Clearing House.[150] To protect themselves, the Clearing Members would then impose similar or usually more stringent margin deposit requirements on their customers. If such customers are non-clearing members, they would in turn collect margin from their non-member customers. SIMEX in any case stipulates the amounts of initial margins which must be obtained by all members from their customers and the amount of margins that must be maintained by customers on open positions.[151] Members are not to accept orders for new trades from a customer unless the minimum initial margin for the new trades is on deposit or is forthcoming within a reasonable time and unless the margin on that customer's existing open positions complies with the existing maintenance requirements or is

[150] See Rules 819 and 820.
[151] See Rule 822.

forthcoming within a reasonable time.[152] A reasonable time has been defined as three business days.[153]

Margin trading is essential to futures trading. It is unrealistic to expect customers to deposit an amount which would fully reflect their potential liability upon maturity of the futures contract. Few contracts are held to maturity and are often offset. Without margin trading, the costs of futures trading would be too high.

Furthermore, it is the margin deposits that provide a source of funds to draw upon when market losses are incurred. Where, after the daily mark-to-market settlement exercise, a loss is incurred, as between the Clearing Member and the Clearing House, a deduction is made from the Clearing Member's margin deposits. The Clearing Member would then make a corresponding reduction in the relevant customer's margin deposits with the Clearing Member. Where the losses deplete the amount of minimum margin required to be maintained as a deposit, a variation margin call is made, by the Clearing House on the Clearing Member, and consequently by the Clearing Member on the customer.

As a note of clarification, the system of margining in the case of futures trading is distinct from the system of margining for equity securities listed and traded on the stock exchange. The functions of such "margins" are different. In futures transactions, margins essentially serve as performance bonds, protecting the

[152] See *ibid.*
[153] See Circular No. CM-22 of 1988 (27 May 1988).

clearing house and clearing members against losses due to any potential financial default on the part of the clearing member and their customers respectively. In the equity market, the term "margin" refers to the percentage of the price of shares that must be paid as a cash down payment, and the amount which constitutes the difference between the price of the share purchase and the margin deposit is an extension of credit by the stockbroker to the buyer of the shares. Although maximum margins are stipulated in the Securities Industry Regulations,[154] margin trading is extended to customers at the discretion of the stockbroker concerned and is a commercial decision to be taken.

In the case of SIMEX futures trading, minimum margin levels are prescribed by the Board from time to time. The amount of margins required to be deposited by any Clearing Member with the Clearing House is calculated and determined on a cumulative gross basis with reference to all open positions (both long and short) for which such Clearing Member is responsible.[155] As a matter of clarification, it should be pointed out that SIMEX requires all Clearing Members to maintain margins with the Clearing House for proprietary positions separately from customers' positions. This means that house and client positions cannot be used to offset one another for margining purposes. Furthermore, margins for customers'

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[154] Made pursuant to the Securities Industry Act, Cap, 289, Statutes of Singapore. See s. 55 of the Securities Industry Act which states: "For the purpose of preventing the excessive use of credit for the purchase or carrying of securities by dealers or member companies, regulations may provide for margin requirements, that is to say, for the amount of credit that may from time to time be extended and maintained on all or specified securities or transactions or class of securities and transactions and for matters connected therewith."

[155] See Rule 820.

positions are computed on a gross basis which means that one customer's long positions cannot be used to offset another's short positions.[156]

Generally speaking, the minimum margin requirements required by the Clearing House from Clearing Members depends on the volatility of the underlying futures contract. As described in the Ministry of Finance's *Report*:

> "The margin deposits required for particular types of contracts are fixed by SIMEX and revised periodically based on market volatility studies in accordance with international norms. SIMEX uses the Standard Portfolio Analysis of Risk ("SPAN") margin system to calculate margins. SPAN evaluates the overall risk of a portfolio of futures and options contracts and matches margins to risk. The system is able to consolidate the risks of a futures instrument with the risks of an option on the same futures instrument. SPAN simulates the reaction of a portfolio to a range of possible market changes and then covers the largest reasonable overnight loss."[157]

The minimum margin requirements required by Clearing Members from their customers would reflect the margin requirements expected of Clearing Members by the Clearing House. In practice, prudent broking SIMEX members would require more than the minimum margin required by SIMEX as a deposit. There is a practical reason as well. In case of adverse and sudden price movements, the margin collected by the broking member would cover the variation

[156] See para. 15.10, Ministry of Finance's *Report*.
[157] Para. 15.9, *ibid.*

margin the member would have to post with a Clearing Member or the Clearing House.

At first sight, it appears anomalous that futures brokers can top up their customers' accounts with their own money. The FTA provides that: "...a futures broker...from time to time may advance from his own funds sufficient money to prevent any or all customers' trust accounts from becoming under-margined."[158] The Rules provide for such action on the part of the futures broker or member.[159] The Rules even permit that a member's money may be paid into a customer's account for "the purpose of opening or maintaining" the customer's account.[160] The extent of such topping up is left to the broking members' own discretion.

Such topping up without the customer remedying the position by correcting the margin deficit effectively allows a certain amount of credit to be extended to the customer by the broking member. However, it is not possible for the allowance of topping-up customers' accounts to be abused in this way as under the Rules earlier mentioned, the SIMEX member is to obtain from their customers minimum amounts of initial margin and variation margin.[161] When a customer's account is undermargined, the member is mandated to call for additional margins to bring the account up to the required margin level.[162] If within a reasonable time the customer fails to comply with such demand, the member may close out the customer's trades or sufficient contracts thereof to restore the customer's account

[158] See s. 37(4), FTA.
[159] See Rule 917:B:4
[160] See *ibid* at a.
[161] See Rule 822.
[162] See *ibid*.

to the required margin status.[163] A member may deem one hour to be a reasonable time before taking closing out action.[164] On the other hand, if the member chooses to give the customer a further grace period, the member may, in the meantime, top up the customer's account to prevent it being undermargined. This, however, cannot go on indefinitely, for the member is required to maintain customer margins. If the member fails to do so, SIMEX may order such member to immediately close out all or such part of the positions so as to correct the deficiency.[165] Failure to maintain customer margins as required under the Rules is a major offence.[166]

The setting of margin levels is a controversial and sensitive area of futures trading. A high level of margin is prudent insofar as the clearing house is concerned. This ensures financial stability in the event of high volatility. However, margin requirements have been said to restrict trading activity, so that exchanges and brokers in general are anxious that the margin requirements are not unreasonably high.[167] So, while margin levels have to be high enough to ensure the integrity of the contracts traded, margins that are too high as to lead to adverse consequences impacting upon trading volume are to be avoided.[168]

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163 See *ibid.*

164 See *ibid.*

165 See *ibid.*

166 See *ibid.*

167 See note 16 at Chapter 1, Robert W. Kolb, *Understanding Futures Markets*, Fourth Edition, 1994, Kolb Publishing Company at 12. Reference is made to L. Kalavathi and L. Shanker, "Margin Requirements and the Demand for Futures Contracts," *Journal of Futures Markets*, 11:2, April 1991 at 213-237 where it is argued that increasing margins decreases demand for futures positions. Another reference is made to Stanley R. Pliska and Catherine T. Shalen, "The Effects of Regulations on Trading Activity and Return Volatility in Futures Markets," *Journal of Futures Markets*, 11:2, April 1991 at 135-151 where the authors maintain that extremely high margins can reduce liquidity as measured by open interest and trading volume.

168 On the other hand, margins which are too low might attract speculators. In "Prompt treatment for futures shock: Singapore has moved fast to mend its reputation after the Barings havoc," *The Financial Times*, 3 March 1995, Peter Montagnon and Kieran Cooke wrote: "Ironically, SIMEX was particularly proud of the Nikkei futures in which Mr Leeson's losses accumulated. It was

The success of SIMEX's margining system was evident in the Barings debacle. As was mentioned in the Ministry of Finance's *Report*:

> "After the collapse of the Baring Group, SIMEX took over and liquidated BFS's positions. As it transpired, SIMEX held adequate margins and was able to liquidate all of BFS's positions and refund a surplus of US$86 million to BFS. Consequently, the common bond[169] was not triggered and SIMEX and its other clearing members did not suffer any loss."[170]

Offsetting

Few contracts are held to maturity. Most futures contracts are completed through offset or via a reversing trade. To close an open position, a party merely has to sell or buy exactly the same contract that was bought or sold originally. This brings the position in a particular futures contract back to zero.

The offset by liquidation procedure is set out in the Rules.[171] To prevent unintentional liquidation of an open position of one customer merely by the purchase or sale of a contrary contract of similar specifications for another customer, the Rules also provide that offset is not automatic.[172] An offsetting transaction must be reflected as such in the position change sheets submitted to the

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one of the most actively traded instruments on the exchange, attracting business from Japan because Singapore's margin requirements were lower than those in Osaka."

[169] See *The Common Bond System* below.

[170] Para. 15.48, Ministry of Finance's *Report*.

[171] See Rule 805.

[172] See Rule 806.

SIMEX Clearing House for the offset by liquidation to be effective.[173] Position change sheets are to be submitted by Clearing Members every business day after the close of business.[174] The position change sheets are documents which inform the Clearing House of each Clearing member's calculation of its final gross open positions. The submitted position change sheets are used by the Clearing House in working out the margin requirements for each Clearing Member.

Large Position Reporting

Position change sheets are submitted to the Clearing House by Clearing Members. Other members who deal with Clearing Members are required to submit position change sheets to the relevant Clearing Member.[175] However, Clearing Members and other members of SIMEX have to submit to SIMEX a daily report of customers with large positions.[176] These reports are not limited to trades undertaken on SIMEX. They include positions "whether assumed or entered into on the Exchange or elsewhere."[177]

The Rules provide that upon request by SIMEX, the member is to identify the owner and controlling parties of the large positions.[178] It is imperative to establish an effective large trader reporting system, as concentrated trades may

[173] See Rules 806 and 810.
[174] SIMEX Circular No. 15 of 1984 (27 February 1984) states that position change sheets are to be submitted by Clearing Members within three hours of the close of business.
[175] See *ibid* at g.
[176] See Rule 816.
[177] See *ibid*. For the identification of reportable accounts and for the minimum reportable levels for SIMEX and non-SIMEX contracts, see Circular Nos. 86 of 1984 (3 July 1984) and CM-3 of 1986 (5 March 1986).
[178] See Rule 816.

indicate either excessive speculation or an attempt at manipulation, both of which are hazardous to the well-being of a futures exchange.

Indeed, right after the Barings episode, SIMEX had assembled an international advisory panel to recommend best practices on SIMEX.[179] Following recommendations, SIMEX implemented a comprehensive risk management program which includes the heightened monitoring of positions and market concentration of large accounts.[180]

The MAS, consequent to the Barings crisis, has a larger role to play in assessing large trader positions. The post-Barings wave of amendments to the FTR included a provision requiring SIMEX to submit to the MAS on a weekly basis, or at any time upon request by the MAS, a report showing large trader positions which exceeds limits as determined by the MAS from time to time.[181]

The Common Bond System

The "common bond system" refers to the agreement between all the Clearing Members to pool their finances so that they effectively guarantee every contract traded on SIMEX. This agreement and its mechanics are set out in Rule 802. This adds to the peace of mind of those who deal on SIMEX. However, if the margining system is implemented, in the case of a default by a Clearing Member

[179] See para. 15.45, Ministry of Finance's *Report*.
[180] See para. 15.46, *ibid*.
[181] See reg. 28, FTR.

upon its obligations, the margin deposits should be adequate, as in the Barings case, to cover losses suffered by the parties who dealt with the Clearing Member.

In any case, if a Clearing Member fails to discharge its obligations to the Clearing House, Rule 802 provides that its security deposit, its margins on deposit and any other assets or securities available to SIMEX will be applied to discharge the obligations. If these assets are insufficient, the Clearing House may resort to the following sources to make good the loss, in the following order of priority:[182]

a. the surplus funds of SIMEX;

b. the assets of any trust fund established under the Rules; and

c. the security deposits of other Clearing Members.

Any remaining loss will be met from a levy on Clearing Members.[183]

[182] See Rule 802:B:d
[183] See *ibid* at 4.

CHAPTER 5

MARKET PARTICIPATION

1. Market Entry Requirements

SIMEX membership criteria and the MAS's licensing regime under the FTA impact upon the entrance and participation of companies and individuals as brokers and traders in the futures market.

SIMEX Membership

SIMEX has various categories of membership. At present, SIMEX provides four categories of membership in its Rules:[1]

(i) Clearing Members;
(ii) Corporate Non-Clearing Members;
(iii) Individual Non-Clearing Members; and
(iv) Commercial Associate Members.

Both Clearing Members and Corporate Non-Clearing Members have full trading rights on the trading floor and the authority to accept customers' business. However, Clearing Members have the authority to clear trades whereas Corporate Non-Clearing Members do not. Furthermore, both Clearing Members and

[1] See Rules 201 to 203. See generally Chapter 2 of the Rules for the eligibility requirements, the rights, duties and responsibilities of members in the various categories of SIMEX membership.

Corporate Non-Clearing Members must own at least three seats on SIMEX. The Clearing Member must also own one share in SIMEX. As mentioned earlier, only Clearing Members are bound by the Articles as shareholders of SIMEX.[2]

The criteria for Clearing Membership is the strictest, with the highest financial requirements.[3] This is not surprising since only Clearing Members are allowed to participate in clearing procedures. Furthermore, collectively as the Clearing House, the Clearing Members, through the common bond system, guarantee every trade done on SIMEX.

Commercial Associate Members' trading rights are limited to energy futures contracts only. They may trade only for their own account and for their related and associated companies. Obviously, they have no authority to clear trades. They must own at least one seat on SIMEX.[4]

Individual Non-Clearing Members can trade only for their own account but have full trading rights on the trading floor. They must own or lease one seat on SIMEX. Individual Non-Clearing Members are, contrary to the nomenclature, not individuals but companies. However, pursuant to the rules, they are required to be companies with a maximum of two shareholders, with one shareholder being the sole and legal owner of not less than ninety-nine per cent of its issued capital.[5]

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[2] See "SIMEX as Exchange" at Chapter 4 above.
[3] At present, the minimum paid-up capital required by SIMEX of a Clearing Member is S$8 million, whereas the requirement for a Corporate Non-Clearing Member is S$5 million.
[4] At present, the minimum adjusted net capital required by SIMEX of a Commercial Associate Member is S$100,000.
[5] See Rule 203.

MAS Licensing

S. 11 of the FTA provides that a "futures broker" requires a licence from the MAS. S. 12 of the FTA provides that the following types of futures market participant also require a licence issued by the MAS:

(a) "futures broker's representative";

(b) "futures trading adviser";

(c) "futures trading adviser's representative";

(d) "futures pool operator"; or

(e) "futures pool operator's representative".

A futures broker's licence, a futures trading adviser's licence and a futures pool operator's licence are only granted to corporations.[6] Any corporation who so carries on business in any of the above capacities without a licence will be guilty of an offence under the FTA and is liable on conviction to a fine not exceeding S$30,000 or to imprisonment for a term not exceeding 3 years or to both.[7]

A futures broker's representative's licence, a futures trading adviser's representative's licence and a futures pool operator's representative's licence may only be granted to an individual. Any individual who so carries on business as any of the above without a licence will be guilty of an offence under the FTA and is

[6] See s. 12(2), FTA.
[7] See s. 11(3) and s. 12(2), *ibid.*

liable on conviction to a fine not exceeding S$10,000 or to imprisonment for a term not exceeding one year or to both.[8]

The licences issued by the MAS are valid for a period of one year.[9] Applications for new licences and renewals of existing licences are to be made pursuant to the procedure set out in the FTA and the FTR.[10] Apart from particulars required on the prescribed application or renewal forms set out in the FTR, the MAS "may require an applicant to provide it with such further information as it considers necessary in relation to the application."[11]

The MAS shall not refuse to grant or renew a licence without first giving the applicant an opportunity of being heard.[12] Circumstances whereby the MAS may refuse to grant or renew licences were considerably expanded by the 1995 FTA amendments. Previously, the circumstances provided for in s. 14(1) of the FTA were limited to situations where, in brief:

(1) the applicant had not provided information "likely to affect its method of conducting business";

(2) the applicant had entered into a composition or arrangement with creditors or is undischarged as a bankrupt, if an individual;

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[8] See s. 12(2), *ibid.*
[9] See s. 16, *ibid.*
[10] See s. 13, FTA and reg. 5 and First Schedule, FTR.
[11] See s. 13(2), FTA.
[12] See s. 13(3), *ibid.*

(3) the applicant, its officers and employees, if a corporation and his employees and persons associated with him, if an individual, had been convicted of offences involving fraud or dishonesty or have otherwise violated the FTA and FTR; and

(4) when it appeared to the MAS that there were other circumstances which were likely to lead to "the improper conduct of business by, or reflect discredit on the method of conducting the business of" the applicant and its officers and employees, if a corporation and his employees and persons associated with him, if an individual.

The 1995 amendments did some housekeeping in relation to the abovementioned circumstances. Insofar as a corporation was concerned, the original provision only provided that a ground for refusing a licence application was that "the applicant has at any time prior to the application entered into any composition or arrangement with its creditors." This has subsequently been expanded to include:

(i) the applicant or its substantial shareholder being in the course of being wound up or liquidated;

(ii) a receiver or a receiver and manager having been appointed to the applicant or its substantial shareholder;

(iii) the applicant or its substantial shareholder having, whether in Singapore or elsewhere, entered into a compromise or scheme of arrangement with its creditors, being a compromise or scheme of arrangement that is still in operation.

These amendments are uncontroversial and indeed were necessary to bolster the original provisions which were highly inadequate insofar as they related to the potential insolvency of an applicant. The status of the applicant's substantial shareholder has also been taken into account. It is a matter of common sense that an unstable and shaky substantial shareholder would affect the corporate applicant and a licence should not be granted in such circumstances. Similarly, the provision relating to the conviction for *inter alia* offences involving dishonesty now extends to an applicant's substantial shareholder as well.

The 1995 amendments to s. 14(1) of the FTA added more qualitative criteria upon which the MAS may refuse to grant or renew a licence. In the case of a corporate applicant, these are situations where:

(a) the MAS is not satisfied as to the educational or other qualification or experience of the applicant's officers or employees who are to perform duties in connection with the holding of the licence;

(b) the applicant fails to satisfy the MAS that together with itself, its directors, officers, employees and substantial shareholders are fit and proper persons to be licensed;

(c) the MAS has reason to believe that the applicant may not be able to act in the best interests of its subscribers, customers or participants having regard to the reputation, character, financial integrity and reliability of the applicant or any of its substantial shareholders, directors, officers or employees;

(d) the MAS is not satisfied as to the financial standing of the applicant or its substantial shareholder or the manner in which its business is to be conducted;

(e) the MAS is not satisfied as to the record of past performance or expertise of the applicant having regard to the nature of the business which the applicant may carry on in connection with the holding of the licence;

(f) there are other circumstances which are likely to lead to the improper conduct of business by, or reflect discredit on the method of conducting the business of, the applicant or its substantial shareholder or any of the directors, officers or employees of the applicant; and

(g) the MAS is of the opinion that it is in the interests of the public to do so.

In the case of an individual applicant, similar grounds apply. In addition, an individual may be refused the grant or renewal of a licence if the MAS has reason to believe that he "will not be able to perform the functions for which he is licensed efficiently, honestly, or fairly."[13]

The added qualitative criteria allows for greater flexibility and consequent subjectivity on the part of the MAS in the granting, renewal and revocation of licences.[14] In relation to the licensing of financial market participants, the use of subjective criteria by a licensing authority in making licensing decisions is not novel. The Securities Industry Act has included similar criteria regarding an applicant's "good fame and character"[15] as well as the applicant's performance of its duties "efficiently, honestly and fairly."[16]

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[13] See s. 14(1)(a)(vi), *ibid.*
[14] This had caused some concern during the passing of the Futures Trading (Amendment) Bill in Parliament. See Chapter 4, notes 21 and 24, *supra.*
[15] See s. 29(3)(a)(iv), Securities Industry Act.
[16] See s. 29(3)(a)(v) and (b)(v), *ibid.*

It should be observed that the wording in the Securities Industry Act pertaining to the three pronged criteria of efficiency, honesty and fairness uses the conjunctive "and" whereas in the FTA, the disjunctive "or" is used. The phrase "efficiently, honestly or fairly" is used in the FTA with respect to the granting or renewal of an individual's licence as well as in the context of revocation of licences for both individuals and corporations.[17] It is anomalous that only licences of individuals may not be granted or refused renewal on the basis that the MAS has reason to believe that the individual applicant will not be able to perform the functions for which he is licensed "efficiently, honestly or fairly." There is no similar provision regarding the granting or renewal of corporations' licences. At the end of the day, the anomaly is academic for the MAS has at its disposal a host of tools for dispensing with granting or renewing a corporation's licence which are as widely and broadly worded, for instance, the "fit and proper person" test,[18] the "improper conduct of business test"[19] or the "interests of the public" test.[20]

There have been no instances in the futures trading context whereby the courts have had the opportunity to consider the application of the above criteria. Using analogous authority from cases regarding licensed participants in the futures industry may cause difficulty due to the differences in wording in the relevant legislation. For instance, in *Story v. NCSC*,[21] the Australian courts had occasion to

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[17] See s. 20(2)(a)(v) and (vi), FTA. The provisions as to revocation of a licence on the grounds of the licensed person or its directors or employees in the case of a corporation not performing his or their duties "efficiently, honestly or fairly" were in the original FTA.
[18] See s. 14(1)(b)(vii), *ibid.*
[19] See s. 14(1)(b)(xi), *ibid.*
[20] See s. 14(1)(b)(xii), *ibid.*
[21] (1988) 13 ACLR 225.

examine the meaning of the words "efficiently, honestly *and* fairly." The court emphasized the "conjunction" of inefficiency, dishonesty and unfairness.[22]

The use of the disjunctive "or" in the FTA suggests either inefficiency, dishonesty or unfairness is all that is required. In other words, the Singapore legislature seems to adopt the view that an honest but inefficient licensee can do as much harm as an inefficient but dishonest one. Despite the difference in wording, it would still be helpful to discuss *Story v. NCSC* regarding the individual criteria of efficiency, honesty and fairness. Young J opined:

> "So far as "efficient" is concerned, someone is an efficient person or performs his duties efficiently if he is adequate in performance, produces the desired effect, is capable competent and adequate...
>
> "I do not think I need dwell on the meaning of the word "honestly" except to remark that it is significant that it is used in conjunction with the word "fairly". Those words tend to give the flavour of a person who not only is not dishonest, but also a person who is ethically sound, indeed, the sort of person reflected in the words of Psalm 15."[23]

With respect, deciding whether a man is either efficient, honest or fair on the above basis is an unenviable task. Yet it has to be done and has been done. On

[22] Young J, *ibid* at 234 stated: "Considerations of this nature incline my mind to think that the group of words "efficiently, honestly and fairly" must be read as a compendious indication meaning a person who goes about their duties efficiently having regard to the dictates of honesty and fairness, honestly having regard to the dictates of efficiency and fairness, and fairly having regard to the dictates of efficiency and honesty."

[23] See *ibid* at 235. Psalm 15, New International Version: "He whose walk is blameless and who does what is righteous, who speaks the truth from his heart and has no slander on his tongue, who does his neighbor no wrong and casts no slur on his fellowman, who despises a vile man but honors those who fear the Lord..."

the facts of *Story v. NCSC*, Young J decided that the dealer in question who had provided inaccurate information to a customer to induce the customer to deal in certain securities had fallen short of the level of efficiency reasonably expected of a dealer in carrying out his functions under the relevant securities legislation. However, it was further held that just because there was a finding of inefficiency, it did not necessarily follow that the dealer's licence should be revoked. It smacked more of a punitive measure than the protection of the public to revoke a licence based on one careless mistake.[24]

Similarly, it should be noted that the jurisdiction of the MAS to mete out licences was meant to protect the public.[25] S. 14(1) of the FTA allows the MAS discretion by the use of the word "may" in refusing to grant or renew a licence. The word "may" is also used in s. 20(2) in relation to the MAS's discretion to revoke a licence. Particularly in the case of revocation of licences, it should be impressed that the jurisdiction to revoke licences is to protect the public and not to punish the licensee.

The ubiquitous phrase "fit and proper person" found in s. 14 of the FTA has been examined in cases relating to the licensing of market participants in the securities industry. In *P.B. Chapman v. Deputy Registrar of Companies*,[26] it was found on the facts that the licensee had backdated contract notes at a customer's request, knowing that the purported contract had not been concluded on the dates

[24] See *ibid* at 247.
[25] See *ibid* at 239. Young J recognized that the decision to revoke should only be taken if, for the public's protection, the dealer should not be permitted to trade.
[26] [1977] 2 MLJ 5.

shown on the contract notes. It was held that he was not a "fit and proper person" to hold the relevant licence which allowed him to deal in securities.

Even criteria, which at first blush, do not appear excessively difficult to interpret could be subject to interpretative problems. For instance, it has been queried whether the "educational or other qualification or experience" criteria could be fulfilled by a bachelor of business degree. In *Doughty v. Corporate Affairs Commission*,[27] the Australian courts held that based on the evidence in the case, in order to be able to give investment advice on securities, it was essential for the applicant to have experience in a subordinate but responsible position first. and that a bachelor of business degree was not adequate.[28]

Insofar as the MAS has ample discretion in deciding whether a licence should be issued, it has ample discretion over the form of the licence issued. A licence may be granted or renewed subject to such conditions or restrictions as the MAS thinks fit.[29] Furthermore, during the course of the licence, conditions or restrictions may be imposed by the MAS or existing conditions or restrictions may be varied, by notice in writing to the licensee.[30] If a person contravenes or fails to comply with any condition or restriction stipulated in his licence, that person would

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[27] (1988) 13 ACLR 612.

[28] On the facts, the applicant was a butcher turned businessman with an accounting practice who had commenced a Bachelor of Business course at Ku-ring-gai College. In support of his application for a licence, the applicant had submitted examples of his written advice given to clients of his accounting practice. These were criticized by the head of the School of Financial & Administrative Studies at Ku-ring-gai College and the nature of the criticism supported the view that the applicant needed more practical experience under supervision adequately to apply the theoretical knowledge he had acquired. See *ibid* at 617.

[29] See s. 15(1), FTA.

[30] See s. 15(1A), *ibid*.

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[29] See s. 15(1), FTA.

[30] See s. 15(1A), *ibid*.

be guilty of an offence although the relevant section in the FTA does not provide for any specific penalties.[31]

Contravention or failure to comply with conditions or restrictions attached to the licence would constitute grounds for the revocation of the licence by the MAS.[32] Any of the grounds in s. 14(1) of the FTA would also suffice to be a ground upon which the MAS may revoke a licence.[33] In the case of an individual this includes the ground that "the Authority has reason to believe that the applicant will not be able to perform the functions for which he is licensed efficiently, honestly or fairly." Other grounds set out in s. 20 of the FTA upon which the MAS may revoke a licence are *inter alia*, the failure or cessation of the licensed business, the revocation of the main licence with respect to a representative's licence and, as mentioned above, "if the Authority has reason to believe that the licensed person has not performed his duties efficiently, honestly or fairly."[34]

Minimum Financial Requirements

Apart from subjective criteria, corporate applicants for a futures broker, a futures trading adviser or a futures pool operator licence are required to meet and continue to meet objective minimum financial requirements prescribed by the MAS.[35] The detailed financial requirements are set out in the FTR.[36]

[31] See s. 15(2), *ibid.*
[32] See s. 20(2)(a)(vi) and (b)(vii), *ibid*
[33] See s. 20(2)(a)(i) and (b)(i), *ibid.*
[34] See s. 20, *ibid.*
[35] See s. 24, *ibid.*
[36] See regs. 11A, 11B, 11C and 12, FTR.

Futures trading advisers and futures pool operators need only meet requirements pertaining to paid-up capital. The paid-up capital of a futures trading adviser and futures pool operator cannot be reduced without the prior approval of the MAS.[37] More onerous financial requirements are placed on the futures broker. First, the amount of paid-up capital required of a futures broker is higher than that of a futures trading adviser or a futures pool operator. Similarly, the paid-up capital of a futures broker cannot be reduced without the prior approval of the MAS.[38] Next, apart from meeting the particular requirements as to paid-up capital, the futures broker also has to meet requirements pertaining to its adjusted "net capital."[39] "Net capital" roughly means the amount by which current assets exceed liabilities.[40] Having minimum adjusted net capital requirements limits a corporation's liabilities and prevents a corporation from being overleveraged.

The FTA stipulates that any inability to comply with the minimum adjusted net capital requirements must be reported by the futures broker immediately to the MAS.[41] Furthermore, the futures broker is to cease carrying on its business as a futures broker otherwise than for the purpose of giving effect to transactions entered into before it was aware of the non-compliance.[42] The MAS may permit the futures broker to continue carrying on its business on whatever conditions it may impose.[43] Or, it may suspend the futures broker's licence.[44]

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[37] See regs. 11B and 11C, *ibid.*
[38] See reg. 11A(6), *ibid.*
[39] See reg. 12, *ibid.*
[40] For definition of "net capital," see reg. 12(5), *ibid.*
[41] See s. 24A(1)(a), FTA.
[42] See s. 24A(1)(b), *ibid.*
[43] See s. 24A(2), *ibid.*

It is recognized that a sudden cessation of business on the part of the futures broker might do more harm than good for customers of the futures broker. The FTR sets out various options for the MAS in handling the situation. Depending on the extent and period of non-compliance with net capital requirements, the MAS at its discretion may direct the futures broker to immediately do any one or more of the following: *inter alia*, transfer customers' futures trading to another futures broker, cease increases in positions or "operate its business in such manner and on such conditions as the Authority may determine."[45] The MAS is allowed a generous amount of flexibility in dealing with a non-compliance situation. Another direction that the MAS may make in less serious cases of non-compliance is to require the submission of statements pursuant to reg. 12(6) of the FTR on a weekly basis instead of on a monthly basis. This would allow the MAS to monitor the situation whilst preventing disruption to business.

To ensure that futures brokers continue to meet the adjusted net capital requirements, under reg. 12(6), futures brokers are to prepare and lodge monthly statements in a prescribed form with the MAS.[46] These are statements which set out the futures broker's financial condition, the computation of adjusted net capital and the segregation and location of segregated customers' funds.[47] The assets and liabilities of the business are to be presented in these statements such that "the

[44] See *ibid.*
[45] See reg. 12(3A)(iii), FTR.
[46] See reg. 12(6), *ibid.*
[47] See Forms, 21, 22 and 23, *ibid.*

statements give a true and fair view of the state of affairs."[48] This ensures that the MAS is continually and periodically informed of a futures brokers' financial situation.[49]

Accounts and Audit

Apart from submitting monthly statements pursuant to reg. 12(6) of the FTR, every financial year, the futures broker has to submit to the MAS a "true and fair" profit and loss account and a balance sheet of the futures broker.[50] Accounts of futures brokers are required to be kept in a way approved by the MAS[51] and be audited.[52] Futures brokers are required to appoint an auditor to audit their accounts.[53] However, if the MAS is not satisfied with the performance of the auditor it can require the futures broker to appoint another auditor to replace the prior auditor.[54]

Under s. 28 of the FTA, auditors appointed by the futures broker are under an obligation to report any matter which "adversely affects or may adversely affect the financial position of the futures broker to a material extent" to the MAS.[55] Furthermore, auditors of futures brokers are required to report to the MAS where accounting records are not kept in accordance with the FTA and where customer

[48] See reg. 12(6)(b), *ibid.*
[49] Reg. 12(6) was amended by GN S 352/96 to provide for monthly instead of quarterly statements. The amended regulation came into effect on 2 January 1997.
[50] See s. 27, FTA.
[51] See s. 25, *ibid.*
[52] See s. 26, *ibid.*
[53] See *ibid.*
[54] See s. 27(4), FTA.
[55] See s. 28(a), *ibid.*

accounts are not properly segregated in accordance with the FTA.[56] If such a report is made by the futures broker's auditor under s. 28, the MAS may then appoint its own auditor and the appointed auditor would have extensive powers to examine and audit the books, accounts and records of the impugned futures broker.[57]

In any case, under s. 35 of the FTA, the MAS has the power to appoint its own auditors for futures brokers, futures trading advisers or futures pool operators, and even SIMEX itself. Where such an appointment is made, the FTA obliges the appointed auditors to report matters of breaches or non-observances of the FTA to the MAS immediately.[58]

For breaches of certain of the accounts and audit provisions of the FTA, a licensed participant may be liable to fines ranging from S$10,000 to S$30,000 or imprisonment. In the case of a corporation, the fines might be inconsequential and the threat of a jail term is an empty one. The greatest punishment to a licensee is perhaps the loss of the licence.

As far as the auditors are concerned, no penalty is provided in the FTA regarding the failure to perform any of the duties and obligations required of them under the FTA. Auditors are essential in the practical working of the regulatory framework. Due to the limited manpower and resources of the MAS, there is

[56] See s. 28(b), *ibid.*
[57] See s. 30, *ibid.*
[58] See s. 35, *ibid.*

certain dependence on auditors. Although no criminal penalties are provided, it is inevitable that the failure to perform their required duties would affect the auditors' professional reputation and relationship with the MAS. Auditors, who are grossly or professionally negligent in performing their duties, face the risk of being permanently or temporarily barred from acting as auditors for futures brokers.[59]

2. Licensed Market Participants

Futures Broker

The FTA defines a "futures broker" to be:

> "a person, whether as principal or agent, who…carries on the business of soliciting or accepting orders, for the purchase or sale of any commodity under a futures contract on any Exchange or futures market." [60]

The 1995 amendments also expanded the definition of a "futures broker" to include one who "carries on the business of leveraged foreign exchange trading." The amendments then also included in the licensing provisions of futures brokers in s. 11 certain exemptions from licensing requirements.

The exemptions to section 11(1) are found in section 11(2). Exemptions from the licensing requirements extend only to the following persons:

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"(a) a person who carries on the business of leveraged foreign exchange trading only with accredited investors but not with any other person;

(b) a person who carries on the business of trading in futures contracts or leveraged foreign exchange trading for his own account or for the account of a related corporation or related person;

(c) a person who is licensed under the Securities Industry Act or who is exempt under that Act or any regulations made thereunder from holding such a licence and who trades in futures contracts or enters into leveraged foreign exchange trading wholly in connection with and solely incidental to the purchase or sale of securities or for the purpose of hedging a portfolio of securities."[61]

As mentioned earlier, since the definition of "futures market" incontrovertibly includes foreign futures exchanges,[62] a futures broker is an individual or corporation who accepts or solicits orders to buy and sell SIMEX futures, as well as futures traded exchanges elsewhere.

Futures Trading Advisers

A "futures trading adviser" is defined in the FTA as a person who:

"(a) carries on the business of advising other persons...concerning futures contracts, foreign exchange trading or leveraged foreign exchange trading, including advice on whether to engage in trading in futures contracts, foreign exchange trading or leveraged foreign exchange trading;

[61] See s. 11(2), *ibid.*
[62] See "Futures Market" at Chapter 3 above.

(b) as part of a regular business, issues or promulgates any analysis or report concerning futures markets or foreign exchange markets; or

(c) pursuant to a contract or an arrangement with a client, undertakes on behalf of the client (whether on a discretionary authority granted by the client or otherwise) trading in futures contracts, foreign exchange trading or leveraged foreign exchange trading for the purposes of managing the client's funds..."[63]

Excluded from the definition of futures trading adviser are banks, merchant banks, accountants, lawyers and newspapers.[64]

The 1995 amendments expanded the definition of "futures trading adviser" to include the management of funds, whether on a discretionary or non-discretionary basis, for investment in futures contracts, foreign exchange trading and leveraged foreign exchange trading as the legislature recognized that the futures trading adviser's scope of activities had been expanded to include the management of customers' funds.[65] Prior to the 1995 amendments, a futures trading adviser's licence could be granted to either a corporation or an individual. A futures trading advisers' licence can now only be granted to a corporation.[66] This is an additional safeguard for the customer as corporations are subject to additional regulation under the Companies Act.

[63] See s. 2, FTA.
[64] See s. 2, *ibid.*
[65] See remarks of Dr Hu at the Second Reading of the Futures Trading (Amendment) Bill, Singapore Parliamentary Debates, vol. 64 at col. 48 (1 March 1995).
[66] See s. 12(2), *ibid.*

The FTA defines a "futures pool operator" as:

> "any person who carries on a business, in the nature of a unit trust or other interest to which Division 6 of Part IV of the Companies Act applies, and who in connection therewith accepts or receives from other persons funds, security or property, either directly or through capital contributions, the sale of shares or other forms of security or otherwise for the purpose of trading in futures contracts, foreign exchange trading or leveraged foreign exchange trading..."[67]

Futures pools essentially consist of a collection of funds used to engage in futures trading activities. Typically in the US, a number of individuals contribute funds to form the futures pool. The pool operator then uses those funds to engage in speculative futures trading. The individuals who contributed monies to the pool own a share of the entire pool. Thus, it is similar to a unit trust in which individuals contribute funds for investment in securities.

The FTA stipulates that a futures pool operator's licence may only be granted to a corporation.[68] At present, there are no futures pool operators or futures pool operator's representatives licensed in Singapore.[69]

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[67] See s. 2, FTA.
[68] See s. 12(2), *ibid.*
[69] This has been attributed to the fact that the minimum financial requirements are onerous. At present, to minimum paid-up capital requirement for a corporation seeking a futures pool operator's licence is S$3 million. See reg. 11C, FTR.

Representatives

A futures broker's representative, a futures trading adviser's representative and a futures pool operator's representatives are essentially those individuals who are in the direct employment of, act for, or by arrangement perform the functions of a futures broker, futures trading adviser and futures pool operator respectively.

One of the 1995 FTA amendments which made a significant practical impact upon market participants is the amendment made to the definition of "futures broker's representative" to include those in the direct employ of futures brokers, including directors, officers or employees.[70] The effect is that directors, officers and salaried employees of a futures broker who perform the functions on behalf of a futures broker are required to be licensed as futures broker's representatives. Previously, such persons were exempt from the licensing requirements. The added licensing requirement for such persons is said to "ensure that only individuals with the requisite experience, qualification and integrity are permitted to participate in the financial futures industry."[71]

Unlicensed Market Participants

The consequences of a failure to obtain the necessary licence before embarking upon a futures broker's, futures trading adviser's or futures pool

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[70] See definition of "futures broker's representative" in s. 2, FTA.

[71] See remarks of Dr Hu at the Second Reading of the Futures Trading (Amendment) Bill, Singapore Parliamentary Debates, vol. 64 at col. 48 (1 March 1995).

operator's business, as mentioned, could be a fine or imprisonment.[72] Furthermore, any contracts entered into could be considered "illegal." The Singapore courts in *Tokyo Investment Pte Ltd v. Tan Chor Thing*[73] have held that the FTA was meant to prohibit transactions entered into by unlicensed futures brokers and any such transactions should be treated as illegal and unenforceable. Yet the respondent in the matter was allowed to recover property pledged to the unlicensed broker.

> In brief, the facts of *Tan Chor Thing* are as follows:
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> Tokyo Investment Pte Ltd ("Tokyo") were a company in Singapore, who had been convicted under s. 11(1)(a) of the FTA for having carried on the business of trading in Hang Seng futures without a licence. Tan Chor Thing ("Tan") had pledged shares to a company called Heritage Commodities Pte Ltd ("Heritage") through whom he had a trading account. The account had been closed but the shares were not returned. Subsequently the shares were seized by the police in the course of investigations concerning Tokyo. Tokyo claimed to be entitled to the shares on behalf of their principal, a Hong Kong company ("HK"), which was also unlicensed. Tokyo contended that the shares were pledged to HK Co as security for the trading account of Tan's brother, with Tan's consent. Tan denied giving consent to such an arrangement.

The court had to consider the question of illegality: did the fact that neither Tokyo nor HK was registered under the FTA render the transactions entered into between Tan's brother and HK, and the security furnished by Tan on behalf of his

[72] See s. 11(3) and s. 12(4), FTA.
[73] [1993] 3 SLR 170.

brother, illegal and unenforceable?[74] The court held that Tan should be assisted in recovering the shares as he was not *in pari delicto* with HK. As phrased by Chao Hick Tin J:

> "The scheme of licensing prescribed under the FT Act is intended to protect the class of investing public of which the respondent [Tan] was a member. The Act places the burden to obtain a licence on the person who seeks to trade as a futures broker and not on the clients. the penalty is imposed on the unlicensed futures broker. Accordingly, the respondent [Tan] was not *in pari delicto* with the second appellants [HK]. It further seemed to us that in line with the policy behind the Act the respondent [Tan] must be allowed to recover the shares; otherwise we would be encouraging illegality rather than deterring it."[75]

Tan was not relying on the illegal agreement to found his claim to possession of the shares or to support the claim, and he was a member of the class of investing public which the FTA was intended to protect. In addition, neither Tan nor his brother knew that they were dealing with an unlicensed futures broker. It is pertinent that Tan who sought possession of his shares was the customer and not the broker.

3. The SIMEX "Local"

The SIMEX "Local" is an Individual Non-Clearing Member of SIMEX.[76] Unless such a member is licensed under the FTA as a futures broker or a futures

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[74] See *ibid* at 174I.
[75] See *ibid* at 179H-I.
[76] See Rules 203, 227 and 230.

broker's representative, that person cannot carry on the business of soliciting or accepting orders for the purchase or sale of futures. Such a SIMEX "Local" would then be trading solely for and on his own behalf.

On the other hand, there exists a group of SIMEX "Locals" who do not trade on their own behalf, but take orders from other members of SIMEX. These are the "order fillers" who are exempted from the licensing provisions of the FTA. Reg. 22B(6) of the FTR describes an "order filler" as "an individual who is registered as a member of an Exchange for the purpose of entering into contracts on the floor of that Exchange only on behalf of members thereof which are licensed as futures brokers under section 11(1) of the Act."

As provided in reg. 22B(1) of the FTR, an "order filler" need not comply with the licensing requirements for futures brokers or futures brokers' representatives and consequently need not present accounts to the MAS in accordance with Part IV of the FTA. Furthermore, order fillers need not segregate customer funds in accordance with s. 37 of the FTA, nor comply with s. 37A in relation to front running, 37B in relation to trading against a customer, or 37C in relation to cross-trading. However, it should be noted that as a member of SIMEX, the "order filler" is bound by the Rules and will still have to comply with the rules as to the priority of customers' orders[77], trading against customers' orders[78] and cross trades[79]. As is obvious, "order fillers" need not comply with s.

[77] See Rule 520.
[78] See Rule 521.
[79] See Rule 523.

39 of the FTA which requires a risk disclosure statement to be provided to a customer.

A SIMEX "Local" as an Individual Non-Clearing Member of SIMEX is not allowed to execute a contract on SIMEX unless qualified by a Clearing Member.[80] Qualification is defined in the Rules[81] as the guarantee of a Clearing Member to accept liability for all contracts executed on SIMEX by a member which it has qualified until such trades have been accepted by the Clearing House. "To qualify is to so guarantee to accept the liability." The Individual Non-Clearing member is obliged prior to executing any trade on SIMEX to inform SIMEX in writing of the Clearing Member who shall have agreed to qualify him.[82]

4. Inter-Member Issues

Out-Trades

Disputes between Clearing Members usually concern "out-trades." Out-trades occur when clearing memoranda is rejected. As mentioned earlier, for the clearing house system to function, Clearing Members must submit to the Clearing House clearing memoranda.[83] Clearing memoranda which do not match the

[80] See Rule 507. Furthermore, a non-clearing member cannot be qualified by more than one Clearing Member at any time.
[81] See Chapter 1 of the Rules.
[82] See Rule 230.
[83] See "SIMEX as Clearing House" at Chapter 4 above and Rule 808:A.

memoranda submitted by the opposite Clearing Member are automatically rejected in accordance with the Rules.[84] Such unmatched trades are called "out-trades."

The term "clearing memoranda" actually relate to a series of clearing slips submitted constantly throughout the day by buyers and sellers to every transaction.[85] The clearing slips would include the buyer or seller's own name or symbol, the name of the Clearing Member clearing the trade, the opposite party on the floor, the opposite Clearing Member as well as the date, price, quantity, commodity and contract month and time bracket.[86] These slips are required by SIMEX to be submitted within thirty minutes after execution of the trade. After the clearing slip is submitted, the buyer's slip is matched with its corresponding seller's slip by SIMEX. This is performed at regular intervals during the trading day and SIMEX provides the results of the matching processes to show a listing of transactions which have been successfully matched with the opposite side and also those which were not, being out-trades. At the end of each trading day, SIMEX will perform a final matching run.[87]

Where an out-trade occurs, Rule 808:D states that "Clearing Members will be notified of the discrepancy and will be required to adjust the differences between themselves and to resubmit corrected clearing memoranda within a time limit

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[84] See Rule 808:C.

[85] The clearing procedure pursuant to Rule 808 is effected by a "Double-Slip Trade Matching System" which is described as follows. The information is obtained from Circular No. 15 of 1984 (27 February 1984).

[86] See Rule 508. Providing such details on the clearing slips is part of the duty of those who trade on the floor to aid his respective Clearing Members in the clearing of trades.

[87] This entire process from the submission of clearing slips to the final matching run is referred to as the "Double-Slip Trade Matching System." See note 85, *supra*.

specified by the Clearing House." It is impractical to expect Clearing Members to resolve the discrepancies, where they have only qualified trades[88] and were not actively involved in the execution of such trades. Therefore, SIMEX provides out-trade reports to all members. SIMEX has stipulated in an internal circular that each member is to use its out-trade reports to examine its own records, consult the person who executed the trade, and where appropriate, discuss with the opposite firm to resolve the difference in data.[89]

Discrepancies can arise when both parties to a trade have submitted clearing slips for matching but the details of the key fields on the slips do not agree. Discrepancies can also arise where one party to the transaction did not submit a clearing slip.[90] Out-trades, therefore, are a rife area of dispute amongst members *inter se.*

The fact is that few of these disputes are arbitrated. This may be because at the end of the day, the mistake resulting in an out-trade originates on the trading floor. Due to the hectic environment on the trading floor, it is inevitable that mistakes do occur. There is a spirit of give and take amongst those executing trades and ways and means are found for resolving matters quickly and amicably. SIMEX literature has stated:

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[88] See Rule 507. All non-clearing members have to be qualified by a Clearing Member. For the definition of "qualification," see Chapter 1 of the Rules

[89] See Circular No. 15 of 1984 (27 February 1984) on the "Double-Slip Trade Matching System" (Rule 808).

[90] See *ibid.*

"Generally, the trader responsible for the error will bear the loss, although, when it appears to have been an honest mistake with no clear fault on either side, the traders involved will split any loss arising from the error between them."[91]

Give-Up Trades

The "give-up" trade is another potential source for inter-member disputes. A "give-up" trade occurs either when a Clearing Member executes a trade on the floor but gives up the contract to another Clearing Member, or when a non-clearing member executes a trade on the floor but gives up the contract to a Clearing Member other than its qualifying Clearing Member.[92] The give-up occurs after the trade is executed on the floor but before the trade is submitted to the clearing house and subjected to matching.[93] As mentioned earlier, a clearing slip has to be submitted within thirty minutes of an execution of a trade. A "give-up" has to take place within these thirty minutes.

Give-up trades were not initially recognized by the Rules. Rule 827 has been amended to provide for give-up trades. The relevant provisions as to give-up transactions are Rule 827:1:e and Rule 827:3. When faced with the concept of a give-up transaction, it is inevitable that one questions why members would want to give up trades.

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91 See *The SIMEX Locals - Emerging Entrepreneurs*, 1985, SIMEX Marketing Department at 19.
92 See note 88, *supra*.
93 In accordance with the clearing procedures in Rule 808.

There appears to be two types of give-ups occurring on SIMEX.

(a) A non-member customer may instruct its futures broker, either a Clearing Member or a non-clearing member, to give up a trade to a particular Clearing Member. The customer may use the services of several futures brokers, both Clearing Members and non-clearing members, to execute trades but may wish to centralize the clearing of trades with one Clearing Member.

(b) A Clearing Member may instruct an order-filler to execute a trade which would then be given up to it. Such a Clearing Member is not the qualifying Clearing Member of the order-filler.. Therefore, instead of the trade being cleared by the order-filler's qualifying Clearing Member, it is cleared through the Clearing Member who placed the order and gave the give-up instruction.

In scenario (b), there was always the danger of Clearing Members who had so instructed order-fillers to execute trades to be given up to them, to engage in the unscrupulous practice of rejecting such trades, especially when the trade turns bad, resulting in the qualifying Clearing Member of the order-filler bearing the loss. A dispute would consequently arise between the qualifying Clearing Member and the instructing Clearing Member purporting to reject the trade. The amended Rule 827 provides a route intended to facilitate the better management of such disputes by SIMEX. It essentially provides:

(i) in the event of the instructing Clearing Member purporting to reject a trade or trades which give or gives rise to an aggregate maintenance margin obligation of S$3 million or more, SIMEX may require the said

Clearing member and/or the qualifying Clearing Member of the order-filler to produce evidence to SIMEX regarding the purported rejection;

(ii) if SIMEX is not satisfied with the evidence adduced, it is empowered to require the instructing Clearing Member to accept the transfer of all or such part of the trades purported to have been rejected;

(iii) the instructing Clearing Member must always be ready and willing when it rejects a trade to produce evidence immediately validating any purported rejection.

Where the instructing Clearing Member did give the instruction to execute the trade to be given up to it, it is virtually impossible for it to assert that a rejection is a proper and valid one.

Rule 827 further provides that any decision by SIMEX "shall be without prejudice to the rights of any Member to pursue its contractual rights inter se either by arbitration pursuant to the Rules (or where permitted) by litigation."

CHAPTER 6

DUTIES OF BROKER TO CUSTOMER

1. Agency Relationship

Whether the relationship between a broker and customer is one of principal and principal, or, principal and agent, has generated much discussion and conflicting views. The FTA definition of the term "futures broker" describes a broker "whether as principal or agent."[1] The case law is in a confused state and the issue remains unresolved. The difficulty arises because the peculiar arrangements of a futures exchange make it difficult to pigeonhole the broker-customer relationship into the usual contractual or agency paradigms.

It comes as no surprise upon an examination of the case law, that the coherent theme appears to be that whether the relationship between broker and customer gives rise to an agency relationship depends very much on the particular factual scenario at hand. Brokers function within a framework of exchange rules and accepted market practices. Different futures exchanges have different rules and market practices, and trading practices allowed on one exchange may be taboo on another.

[1] See s. 2, FTA.

In general, the view that an agency relationship exists between broker and customer is attractive for the following reasons. First, such a relationship would impose upon the broker the duties owed by an agent to its principal, in this case, the customer. Second, in the event of the insolvency of the broker, the customer would retain proprietary rights as principal over monies placed with the broker as margin.

In accordance with this view, Kerr J in *E. Bailey & Co. Ltd v. Balholm Securities Ltd*[2] described the broker and customer relationship in the following terms:

> "Although brokers deal in the market as principals by concluding contracts of purchase or sale in their own name on which they are personally liable to each other, and although their clients will not even know the identity of the other broker let alone that of his client, the relationship between a broker and his client is that of agent and principal and not of buyer and seller."[3]

For all intents and purposes, the terms "client" and "customer" may be used synonymously. The term "customer" is preferred as it is used in the FTA and the FTR. A customer may be roughly defined as a person on behalf of whom the broker deals, or from whom the futures broker accepts instructions to deal in futures.[4]

[2] [1973] 2 Lloyd's Rep 404.
[3] See *ibid* at page 408.
[4] For a legal definition of "customer," see s. 37(9), FTA. However, the definition provided therein is stated to be for the purposes of s. 37 itself. The question as to who is or who is not a customer for the purposes of s. 37 and the segregation of customers' monies is discussed below.

Kerr J relied upon English authorities *Woodward v. Wolfe*[5] and *Weddle, Beck & Co v. Hackett.*[6] There have been Australian authorities which also adopt the position that the relationship between broker and customer is that of principal and agent, for instance, *Jackson Securities Ltd v. Cheesman.*[7] This position is supported by Australian commentators such as Frohlich[8] and Hains.[9] There are other authorities and commentaries which acknowledge that the principal-agent relationship is far from clear, but for the sake of a meaningful discussion of brokers' duties, analogized to those of agents, it was assumed that the relationship between broker and customer is that of principal and agent. This occurred in the Australian case of *Option Investments (Aust) Pty Ltd v. Martin*[10] and in the works of Markovic.[11]

A factor which suggests that the relationship between the broker and customer is one of principal and agent is that the broker often acts upon orders of

[5] [1936] 3 All ER 529.

[6] [1929] 1 KB 321. This is a case involving stockbrokers. Rojers J in *Dalton v. AML Finance Corp Ltd* (1980) ASLC 76-0006 at 86,172 opined that although Kerr J in *E. Bailey & Co. Ltd v. Balhom Securities Ltd* did not specifically say so, he may have concluded that the relationship between broker and customer was one as between agent and principal because of the established line of English case authority that this is the relationship between stockbrokers and their clients. However, Kerr J's position has been less than consistent. In *Wilson, Smithett & Cope Ltd v. Terruzi* [1975] 2 Lloyd's Rep 642, Kerr J stated that the trading machinery on the London Metal Exchange was the same as that described in his judgment in relation to the cocoa trade in *E. Bailey & Co. Ltd v. Balholm Securities Ltd.* However, he then went on to say that the contract made between broker and customer was one between principal and principal!

[7] (1986) 4 NSWLR 484.

[8] See E.F. Frohlich, "Some Features and Legal Aspects of the Futures Industry" (1986) 60 ALJ 224.

[9] See M.G. Hains, "Duties and Obligations of a Futures Broker to his Client" (1987) 3 Aust Bar Rev 122.

[10] [1981] VR 138.

[11] See M. Markovic, "The Futures Broker and Client Relationship in Australia" (1989) 2 Corporate & Business Law Journal 85 and "The Legal Status of Futures Market Participants in Australia" (1989) 7 Company & Securities Law Journal 82.

the customer on a commission basis. In *Woodward v. Wolfe*, Hilbery J expressed this point thus:

> "...the plaintiffs in the case before me did in fact act in every transaction as brokers. They made a genuine contract in the market binding them in respect of that and exactly that which the defendant was buying or selling. That afterwards, because the rules of the association and the market bound them so to do, they sent a form of contract as between themselves and the defendant as direct contractors obscures and, I think, falsifies the true position. It is noteworthy that that contract in express terms adds to the price a charge for brokerage, a charge wholly inconsistent with the plaintiffs being in reality principals in a plain vendor and purchaser contract with the defendant."[12]

Furthermore, where the customer places margin deposits with the broker, it is undoubted that the broker cannot deal with the margin as he pleases. Deferring to an American authority, *Re Rosenbaum Grain Corp*,[13] it was observed that the broker and customer relationship "contemplating as it does the holding by the broker of a customer's money and other property is primarily fiduciary in nature."[14] It should be noted that the term "fiduciary" is not synonymous with "agent." However, a fiduciary's duties are based conceptually on those owed by agents.

It would be appropriate at this point to examine the authorities which go against the proposition that the relationship between a customer and broker is one

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[12] See *Woodward v. Wolfe* at 533.
[13] 103 F. 2d 656 (7th Cir 1939).
[14] See *ibid* at 660.

of principal and agent. There have been English and American cases[15] which state that the relationship between a broker and a customer is that of principal and principal. The most well-known English authority in support of this is *Limako BV v. Hentz & Co Inc.*[16] The Court of Appeal therein dismissed an appeal against a decision of Ackner J in the court below which held in effect that on the London Cocoa Terminal Market Association ("LCTMA"), brokers dealt with their customers as "principal to principal" and therefore entered into "back to back contracts" when trading on the instructions of customers. Ackner J, in turn, had merely upheld an award made by arbitrators appointed under the rules and regulations of the LCTMA.

In the *Limako* decision, the Court of Appeal held that the fact that the brokers were entitled to commission under their contract with the customer did not involve the proposition as a matter of law or as a matter of market practice in the light of the arbitrator's findings that the transaction was and throughout continued to be a transaction of agency and agency alone. It is noted that the Court of Appeal's deference to the arbitrator's findings was a recurrent theme in the judgment. Although acknowledged in the judgment of Megaw LJ for the Court of Appeal that the "true nature of the relevant contract or contracts, and of its or their terms, is a question law," he continued:

[15] See *Limako BV v. Hentz & Co*, note 16, *infra*. In *Board of Trade v. Christie Gain & Stock Co*, 198 US 236 (1905), the US courts stated at 245: "In these pits the members make sales and purchases exclusively for future delivery, the members dealing always as principals between themselves, and being bound practically at least, as principals to those who employ them when they are not acting on their own behalf."
[16] [1979] 2 Lloyd's Rep 23.

"...it is a question of law of such a nature that the practice of the market and the opinions of the arbitrators, as independent persons with knowledge and experience of the market and its practices, must be of very great importance in the decision of the issue of law."[17]

It is submitted that whether the relationship between broker and customer is one of principal and principal or otherwise is a question that depends highly on the market practices in force and the factual matrix of transactions. The differences between the practices of the LCTMA as presented in the *Limako* case and that of SIMEX makes *Limako* a difficult case to apply in Singapore without qualification. Based on the arbitrators' findings of fact, certain differences between market practices on the LCTMA and on SIMEX can be highlighted:

(i) Brokers trading on the LCTMA, upon receiving orders from their customer may place an order in its books for the customer yet need not necessarily preserve a back-to-back position with the clearing house.[18] This is not allowed in Singapore. Brokers of futures contracts in Singapore must execute customers' orders on SIMEX. Failure to do so is an offence known as "bucketing."[19]

(ii) Brokers trading on the LCTMA are permitted to maintain a single account with the clearing house that makes it impossible to distinguish between contracts entered into pursuant to customers' orders from those concluded on the broker's own account.[20] This is not allowed in Singapore

[17] See *ibid* at 25.
[18] See the first instance judgment of Ackner J in *Limako B.V. v. Hentz & Co Inc* [1978] 1 Lloyd's Rep 400 at 402.
[19] See s. 51(1), FTA.
[20] See note 18, *supra*.

as there are clear provisions as to the segregation of customers' accounts in the FTA, the FTR and the Rules.[21]

(iii) Brokers trading on the LCTMA are also permitted to trade for their own accounts against their customers' positions.[22] In Singapore, trading against a customer is an offence under the FTA if done without the customer's prior consent and in accordance with the Rules and the practices of SIMEX.[23] SIMEX has issued circulars which set out a certain procedure to be followed before trading against customers' orders are allowed.[24]

(iv) Brokers who have purchased options on the LTCMA for a customer could exercise the option if the customer fails to do so. Furthermore, a broker who has sold an option for a customer on the LTCMA, could conceivably exercise the option against the customer.[25] This situation would not be allowable on SIMEX. According to the Rules and practices of SIMEX, where brokers have purchased options for a customer and such options are not exercised, if they are in-the-money, these will be automatically exercised. The SIMEX Clearing House accepts all option exercise notices and assigns them through a random selection process to Clearing Members who have sold similar options.[26] In practical terms it is impossible for a broker to exercise an option against a particular customer.

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[21] See s. 37, FTA, reg. 15, FTR and Rule 917.
[22] See note 18, *supra*.
[23] See s. 37B, FTA.
[24] See Rule 521 and Circular No. AM-6 of 1987 (26 March 1987). In short, the customer has to give his written consent to such transactions, the broker has to bid and offer by open outcry at the same price at least three times before the trade can be done and the transaction has to be recorded as a trade against a customer and presented to an official on the floor of the exchange.
[25] See first instance judgment of Ackner J in *Limako*, 1978, at 409 and 412.
[26] See SIMEX contract specifications booklets.

The above differences suggest that the principal and principal analysis is not suited to describe the broker and customer relationship on SIMEX. Indeed, in holding that the relationship was one of principal to principal, the Court of Appeal and Ackner J in *Limako* placed emphasis on the market practice set out in (iv) above which allowed brokers on the LTCMA "to "buy" from themselves the option which they were "selling." Ackner J commented:

> "...if the relationship of broker and client were to be that of principal and agent then there could be no question of the action described...being other than the most obvious breaches of the agent's obligation to his principal. Quite clearly, the market, in allowing such conduct, is only doing so on the basis that it is the accepted practice that brokers act as principals when dealing with their clients and with the clearing house."[27]

That is not to say that on SIMEX, where such practices are not condoned, the position is indubitably that of principal and agent. According to the Rules, brokers are personally liable for all futures contracts entered into on the floor of SIMEX and are deemed to contract on a principal to principal basis, before the SIMEX Clearing House matches the transaction.[28] Once the transaction has been matched and cleared, the broker is in a principal to principal relationship with the Clearing House due to the process of substitution.[29] This appears to be in direct conflict with the imposition of a principal-agent relationship on the customer and the broker. Commented Webster J in *SNW Commodities v. Falik*:

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[27] See judgment of Ackner J in *Limako* at 412.
[28] In the case of SIMEX, see Rule 514 which states that "In all contracts made with one another in the pit, Members shall (whether or not they act as agents for others) be deemed to act as principals and shall accordingly be personally bound by and entitled under such contracts until such contracts have been accepted by the Clearing House."
[29] In the case of SIMEX, see Rule 803.

> "In any event I find it difficult to see how a person who is acknowledged to be in a relationship of principal to principal with a third party in a particular transaction can, in the very same transaction, be regarded as someone else's agent. I can understand that the relationship between those two persons, that is to say the client and the broker, may include some or all of the rights and obligations of principal and agent, but that is not to say that they are principal and agent." [30]

In short, a principal-agent relationship as between customer and broker is ostensibly irreconcilable with the deeming of a principal-principal relationship between broker and the clearing house.

The corollary that the customer or undisclosed principal would have rights and owe obligations, initially to the other party to the trade,[31] and after the process of substitution,[32] to the clearing house, however, seems to be the only problem identified[33] with the imposition of the principal-agent relationship between the customer and the broker. If this, indeed, is the only barrier to the full acceptance of a principal-agent relationship between the customer and the broker, it is a surmountable one. The drawing of the above corollary to a principal-agent relationship is based on the so-called "doctrine of the undisclosed principal" which

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[30] [1984] 2 Lloyd's Rep 224 at 228.
[31] See note 28, *supra*
[32] See note 29, *supra*
[33] This conflict or conundrum was highlighted in Frohlich, note 8, *supra* at 228, Michael G. Hains, "Reflections on the Sydney Futures Exchange Clearing House: The Rise of the Mirrored Contract Theory" (Dec 1994) *Journal of Banking and Finance Law and Practice* 257 at 275.

is recognized as an anomalous legal doctrine. Markesinis and Munday[34] have summarized the position as follows:

> "Since the late nineteenth century a distinguished chorus of writers has despaired of offering any principled explanation for this highly peculiar doctrine. Sir Frederick Pollock, for instance, characterised it as "inconsistent with the elementary doctrines of the law of contract,"[35] whilst Oliver Wendell Holmes thought it was "opposed to common sense."[36] Ames argued that the doctrine of the undisclosed principal "ignores fundamental legal principles" and, for that reason, it was "highly important that it should be recognised as an anomaly."[37]
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> The curious doctrine of the undisclosed principal has provoked a [sic] considerable literature, but defies any entirely satisfactory explanation. Whilst academic writers have variously sought to explain the principal's right of intervention as a form of trust or as a primitive and highly restricted form of assignment,[38] the courts have preferred to justify the doctrine simply on grounds of commercial convenience."[39]

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[34] See B.S. Markesinis and R.J.C. Munday, *An Outline of the Law of Agency*, 3rd edition, 1992, Butterworths at 167-8.
[35] (1887) 3 LQR 359. See also (1898) 14 LQR 2,5. As cited by Markesinis and Munday.
[36] See "The History of Agency" in *Select Essays in Anglo-American Legal History*, vol. 6 at 404. As cited by Markesinis and Munday.
[37] 18 Yale LJ 443 (1909). As cited by Markesinis and Munday.
[38] See notably Goodhart and Hamson "Undisclosed Principals in Contract" [1931] 4 CLJ 320 at 336. The various theories elaborated over the years are passed in review in Stoljar, *The Law of Agency* (1961) at 228-33. As cited by Markesinis and Munday.
[39] Markesinis and Munday cite Lord Lindley in *Keighley, Maxsted & Co v. Durant* [1901] AC 240 at 260I: "As a contract is constituted by the concurrence of two or more persons and by their agreement to the same terms, there is an anomaly in holding one person bound to another of whom he knows nothing and with whom he did not, in fact, intend to contract. But middlemen, through whom contracts are made, are common and useful in business transactions, and in the great mass of contracts it is a matter of indifference to either party whether there is an undisclosed principal or not. If he exists it is, to say the least, extremely convenient that he should be able to sue and be sued as a principal, and he is only allowed to do so upon terms which exclude injustice."

It goes against commercial sense and convenience to adhere blindly to the anomalous legal doctrine of undisclosed principal in the context of futures trading in a clearing house system, to allow the ultimate customer to sue and be sued as a principal. The reality of the situation on SIMEX is that the principal or customer is deprived of any rights and freed from any obligations arising out of a principal-agent relationship with the broker as the Rules deem the broker to contract as principal in relation to other brokers and the Clearing House. The Australian and English courts have consistently stated that a clearing member is personally liable with respect to contracts entered on an exchange, regardless of the type of legal relationship between broker and customer and even when the principal-agent issue was not decided upon.[40]

2. Fiduciary Duties

As mentioned earlier, the term "fiduciary" is not synonymous with "agent." Exact legal definitions are difficult to formulate, but it is undisputed that "fiduciary duties" extend beyond duties which arise out of an agency relationship derived from an agreement. In short, rights and duties of principal and agent may derive either from an agreement into which they have entered or simply from the fiduciary nature of their relationship. An agency relationship has its basis in the law of

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[40] See Hains, note 33, *supra* at note 127. The examples cited are *E. Bailey & Co Ltd v. Balholm Securities Ltd* [1973] 2 Lloyd's Rep 404 at 408; *Dalton v. AML Finance Corp Ltd* (1980) ASLC 76-006 at 86,172; *Option Investments (Aust) Pty Ltd v. Martin* [1981] VR 138 at 142 (affirmed Martin v. *Option Investments (Aust) Pty Ltd (No 2)* [1982] VR 464); *SNW Commodities Pty Ltd v. Falik* [1984] 2 Lloyd's Rep 224 at 228; *Drexel Burnham Lambert International NV. Nasr* [1986] 1 FTLR 1 at 4; and *SCF Finance Co Ltd v. Masri (No 2)* [1986] 2 Lloyd's Rep 366 at 369.

contract, whereas a fiduciary relationship has its basis in equity. McCardie J pointed out in *Armstrong v. Jackson*:

> "The position of principal and agent gives rise to particular and onerous duties on the part of the agent, and the high standard of conduct required from him springs from the fiduciary relationship between his employer and himself. His position is confidential. It readily lends itself to abuse. A strict and salutary rule is required to meet the special situation. The rules of English Law as they now exist spring from the strictness originally required by Courts of Equity in cases where the fiduciary relationship exists."[41]

One of the more succinct and helpful formulations of a fiduciary relationship is that of Ross Innes:[42]

> "Broadly speaking, a fiduciary relationship will arise when one person undertakes to act on behalf of or for the benefit of another, often as an intermediary with a discretion or power that affects the interests of the other, and that other is in a position of vulnerability in relation to the fiduciary. Vulnerability may arise from dependence upon the fiduciary for information and advice, the existence of a relationship of confidence, or the significance of a particular transaction for the parties."

The exact scope of a fiduciary's duty depends upon the nature of the fiduciary relationship. Where the fiduciary relationship is based on a contractual agency, what the fiduciary precisely and specifically undertakes to do on behalf of

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[41] [1917] 2 KB 822 at 826.

[42] Chapter 3, "Fiduciary Duties and Regulatory Rules" in Parry, Bettelheim and Rees, eds, *Futures Trading Law and Regulation* at 46.

the customer is vital in determining the extent of the duty. The difficult question to answer is which came first: the contractual egg or the fiduciary chicken? It is accepted that contractual agreement can vary fiduciary duties. It is also accepted that fiduciary duties arise *extra* contractual agreement. In attempting to weave fiduciary duties into an existing contractual framework, the question is whether the emphasis should be on some notion of agreement and intention of the parties (are fiduciary duties implied?) or on a wider and more abstract consideration of public policy (are fiduciary duties imposed?).

As a starting point, it is useful to delineate the discussion by establishing basic fiduciary duties. There are as many formulations of specific fiduciary duties as there are commentators of the same.[43] The most well known fiduciary duty from which many other specific duties are derived is the duty of the fiduciary not to place himself in a position where his own interest conflict with that of his customer. This is known as the "no conflict" rule and related to this is the "no profit" rule which provides that a fiduciary must not profit from his position at the expense of his customer.

At times the profit is not gained for the fiduciary himself but for another customer. In this case, the fiduciary is still in breach of his duties as he offends another derivative of the "no conflict" rule, the undivided loyalty rule. It has been said that a fiduciary owes undivided loyalty to his customer and therefore must not

[43] See *ibid* at 46-7. The categorization of basic fiduciary duties by Ross Innes is a helpful starting point. See generally in relation to the "no conflict" rule, Markovic, "The Futures Broker and Client Relationship in Australia," note 11, *supra* and Hains, note 9, *supra*.

place himself in a position where his duty towards one customer conflicts with a duty that he owes to another customer. As an extension of this rule, a fiduciary owes a duty of confidentiality to his customer and must not use information obtained in confidence from his customer for the benefit of another customer, nor for his own advantage and profit.

"No Conflict"

The "no profit", undivided loyalty and confidentiality rules are simply derived from the basic rule that a fiduciary shall not place himself in a situation where his duties to the customer conflict with his own interests (his own interests being inclusive of the interests of his other customers.) In *Parker v. McKenna*[44] Lord Cairns LC said of the "no conflict" rule:

> "Now the rule of this court...as to agents is not a technical or arbitrary rule. It is a rule founded on the highest and truest principles of morality. No man can in this court, acting as an agent, be allowed to put himself in a position in which his interest and his duty will be in conflict."

A stockbroker has been held to be under a duty not to compete with his customer[45] and the courts in *SCF Finance Co Ltd v. Masri*[46] had the occasion to decide whether a futures broker was under a similar duty. In that case a broker had commenced proceedings to recover monies from customers who had incurred

[44] (1874) LR 10 Ch App 96 at 118
[45] See *ibid.*
[46] [1986] 1 All ER 40.

substantial losses through trading in commodity and financial futures. The customer pleaded, *inter alia*, that the broker had traded on US futures exchanges on their own account and had put themselves in a position of conflict of interest. Legatt J found that there was no conflict of interest:

> "The procedure and methods of business used by the plaintiffs conformed with the standard of conduct and market practice which is expected of London futures brokers and gave rise to no conflict of interest between the first defendant and themselves..."[47]

The holding that there is no conflict of interest implies that a duty to avoid conflict is owed. The very existence of a duty to avoid conflict presents a problem as there is a view that a broker cannot exonerate himself by saying that the impugned trading "conformed with the standard of conduct and market practice."[48] As Lord Hodson declared in *Boardman v. Phipps*:

> "No person trading in a fiduciary position, when a demand is made upon him by the person to whom he stands in the fiduciary relationship to account for profits acquired by him by reason of his fiduciary position and by reason of the opportunity and knowledge, or either, resulting from it, is entitled to defeat the claim upon any ground save that he made profits with the knowledge and assent of the other person."[49]

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[47] See *ibid* at 47.
[48] Hains, note 9, *supra* at 144, suggests that it would be more appropriate to say that no duty was owed where trading "conformed with the standard of conduct and market practice..." of the exchange where the trading took place.
[49] [1967] 2 AC 46 at 105.

Furthermore, as has been pointed out, the "logic that brokers will avoid a conflict of interest if they act in accordance with market practice has the obvious inherent danger that if a sufficient number of brokers adopt a questionable practice, then there will be no conflict of interest."[50]

To avoid the danger that a number of brokers might be tempted to adopt such questionable practices without sanction, the Rules, FTA and FTR all contain various provisions which prevent brokers from essentially taking positions contrary to their customers, or set out the parameters within which brokers may do so. The following are three situations whereby a broker could be in conflict with a customer's interests by preferring his own or another customer's:

(1) Front-running

Front-running is an abusive practice whereby brokers reserve for themselves favourable prices at which to execute their own orders at the expense of their customers. S. 37A of the FTA provides no futures broker shall knowingly buy or sell any futures contract for "its own account, an account belonging to a connected person or for an account in which it has an interest (including any account over which it has discretion)" when that futures broker has received an order to buy or sell that type of futures contract and has not executed that order "except in accordance with the business rules and practices of an Exchange or a futures market."

[50] See Markovic, "The Futures Broker and Client Relationship in Australia," note 11, *supra* at 93.

For the purposes of s. 37A, a "connected person" of an individual as defined in the FTA[51] means:

"(i) the individual's spouse, son, adopted son, step-son, daughter, adopted daughter, step-daughter, father, mother, brother or sister; and

(ii) a firm or a corporation in which the individual or any of the persons mentioned in sub-paragraph (I) has control of not less than 20% of the voting power in the firm or corporation, whether such control is exercised individually or jointly"

In relation to a firm or corporation, a "connected person" means "another firm or corporation in which the first-mentioned firm or corporation has control of not less than 20% of the voting power in that other firm or corporation."

Front-running is also prohibited in the Rules. Rule 520 relates to the priority of customers' orders and states that: "A Member shall not buy a futures contract for his own account or for an account in which he has an interest when he has in hand orders to buy a futures contract...for others at the market or at the same price." Rule 520 states that the violation thereof is a major offence.

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[51] See s. 2, FTA.

Although the Rules only mention "an account in which he has an interest," which if interpreted narrowly would become more limited in its coverage than s. 37A and lead to evasion of the Rule, the vague language leaves the Rule open to a wide interpretation by SIMEX. It is submitted that it is likely that SIMEX would interpret this Rule widely.[52]

(2) Trading against customer

S. 37B of the FTA provides that:

> "No futures broker shall knowingly enter into a transaction to buy from or sell to its customer any futures contract for its own account, an account of a connected person or for an account in which it has an interest (including any account over which it has discretion), except with the customer's prior consent and in accordance with the business rules and practices of an Exchange or a futures market."

Rule 521 states that a member having in hand a customer order shall not assume the opposite side "for his account or for the account of an entity of which the Member is an officer" except with the "prior written consent of such customer," and that the violation thereof is a major offence. The drafting here is odd for "the account of an entity of which the Member is an officer" does not seem to prevent brokers from using scam and nominee accounts, for instance, a spouse's account, to trade. An interpretation

[52] See SIMEX's interpretation circular in relation to Rule 521 on trading against customers at note 53, *infra*.

circular issued by SIMEX (the "Circular") has addressed this issue and Rule 521 has since included "an account in which he [the member] has an interest."[53]

The prohibition against trading against a customer is not a blanket one. A broker is allowed to trade against a customer outside Rule 521 and s. 37B of the FTA provided, *inter alia*, the customer's consent is acquired. The abovementioned Circular provides that a member cannot trade against his customer's order unless the following criteria are met:

(a) the customer has given written consent;

(b) the transaction is executed in the same manner as a cross-trade;[54]

(c) the fact that the member has assumed the opposite side of the order has to be identified on certain cards or forms used in the order execution process;

(d) such card or form is to be presented to a SIMEX official for verification and initialling; and

(e) the written confirmation of the transaction issued to the customer is to clearly denote the fact that the member has assumed the opposite side of the order.

Furthermore, evasion of Rule 521 by other means is expressed in the Circular not to be tolerated:

[53] See Circular No. AM-6 of 1987 (26 March 1987).
[54] A cross-trade is discussed below. See Rule 523.

"Members are also reminded that resorting to other methods of trading against customer's order, such as the passing of customer's order to another order-filler, or the enlistment of accommodating trader to trade indirectly against the customer's order, will be deemed a violation of Rule 521."

(3) Cross-trading

Cross-trading occurs when a futures broker has in hand at the same time both buying and selling orders from different customers. Disallowing cross-trading prevents the broker from simply matching both orders, and not necessarily getting the best market prices for each.

S. 37C of the FTA provides:

"No futures broker shall knowingly fill or execute a customer's order for the purchase or sale of a futures contract on a futures market, by offsetting against the order or orders of any other person, without effecting such a purchase or sale of the futures contract on the trading floor or electronic futures trading system and in accordance with the business rules and practices of an Exchange or a futures market."

Rule 523 provides that cross-trades may be executed provided the member shall "first bid and offer openly and competitively by open outcry at the same price, stating number of contracts, at least three times in the presence of an Exchange Official" and "[i]f neither the bid nor the offer is accepted within a reasonable time, the orders may then be matched in the presence of and with the approval of the Exchange Official." Furthermore, like trading against a customer, the cross trade is to be clearly identified by the member on the relevant cards and forms, and be verified and initialled by the appropriate SIMEX official. These are safeguards to ensure that the trades are crossed only after participation in the competitive bidding process to ensure the best possible price for the customer.

The violation of Rule 523 has not been expressed to be a major offence and is therefore a minor offence. This suggests that SIMEX views cross-trades as a less serious form of breaching a duty to avoid conflict. On the other hand, the breach of s. 37A in relation to front-running, s. 37B in relation to trading against customers and s. 37C in relation to cross-trading all carry the same penalty, being a fine not exceeding S$30,000 or imprisonment for a term not exceeding 3 years or to both.[55]

Duty of Skill, Care and Diligence

The duty of a broker to exercise skill, care and diligence is not controversial. The standard of care required is. At the extreme end, it has been held that where a broker gives advice to a customer and such advice has resulted in

[55] See s. 40, FTA. Prior to the 1995 amendments, provisions similar to s. 37A and 37B of the FTA were found in the FTR. Contravention of any provision of the FTR was liable on conviction only to a fine not exceeding S$5,000. The prohibition of cross-trades in s. 37C of the FTA was introduced by the 1995 amendments and till then, had only been prohibited in the Rules.

customer's losses increase the longer the broker waits to close out. In *Option Investments (Aust) Pty Ltd v. Martin*,[58] the customer alleged that the broker should have sold the contracts earlier than it did. As a result of the delay, the customer had suffered more losses and it was alleged that the broker was negligent or in breach of a duty to exercise care to make a reasonable sale having regard to the defendant's interest. It was held that the customer could not make out a case of failure to regard his interest or of negligence in the conduct of the sale, by reference to delay alone. Lush J observed:

> "A broker's duty is to execute the orders which his client gives him. He is under no duty to give advice, though if he does he must of course do so honestly and with appropriate skill and ability. He is under no duty, and has no general authority, to initiate transactions, for instance, the sale of securities held, without his client's instructions. The relationship has fiduciary aspects relating to moneys and securities held by the broker, but otherwise the broker's duty is to execute orders..."
>
> "..the giving of authority to a broker to close out his client's open positions upon default in meeting a margins request appears clearly as a right in the nature of security given to the broker to protect himself against liability or loss. It is, in fact, a power of sale given as security to the broker as an actual or contingent creditor of the client."[59]

Lush J's *obiter* observations on a broker's duty in closing out are worth reproduction:

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[58] [1981] VR 138. Affirmed on appeal, *Martin v. Option Investments (Aust) Pt Ltd (No 2)* [1982] VR 464.
[59] See *ibid* at 142.

> "On principle, the broker who closes out must be under a duty to sell in good faith: in most cases sale on an open exchange will satisfy this requirement. Since he sells for the protection of his own interest he is entitled to select the time of sale unless he is otherwise contractually bound. He is bound to have regard in making the sale to the client's interest and may be under a duty to exercise care for the protection of the client's interest. Both these concepts must be understood in the light of the fact that the broker has the power for the protection of his own interest. In any case I do not find it easy to give practical content to these last stated principles in a situation where the broker has the right to choose the time of sale and sells through an open exchange."[60]

Similarly, in *Dalton v. AML Finance Corp Ltd (No 2)*[61] where the customer alleged that the broker was under an obligation to sell contracts immediately upon its repudiation by the customer, the court held that no such obligation existed and Rogers J opined:

> "...it must be self-evident that a broker must be given a great deal of freedom of movement in determining when and in what amount he should make a margin call, and whether or not upon failure to meet a margin call he should close out a contract then and there or whether his interests are better served by postponing the sale."

It is understandable that the courts do not wish to stipulate what is or is not reasonable, with regard to a commercial decision to close out.[62]

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[60] See *ibid* at 143.
[61] (1980) ASLC 76-006 at 86,174. Affirmed on appeal (unreported, NSW Court of Appeal, 16 April 1982).
[62] The courts have been prone to decide in favour of brokers in situations where brokers do close out for failure to meet margin calls, and allowing brokers a certain amount of leeway in making the decision. For example, see further, *Drexel Burnham Lambert International NV v. Mohamed Schaker Salim Abou El Nasr* [1986] 1 Lloyd's Rep 356, *SNW Commodities v. Falik* [1984] 2

3. Statutory Duties

A broker is specifically imposed duties towards its customers under the FTA and FTR. Those relating to the conduct of trade, for instance, front-running have already been discussed. Further broker's duties relating to the customer include the issue of contract confirmation notes,[63] the provision of monthly confirmation statements[64] and the duty of confidentiality with regard to customer's orders.[65] Two further duties require more discussion. These are the provisions relating to the segregation of customers' monies and the requirement of risk disclosure.

Segregation of Customers' Monies

S. 37 of the FTA provides that every futures broker shall:

> "(a) treat and deal with all moneys, securities or property received by him from a customer as belonging to that customer; and
>
> (b) account in a separate trust account, designated or evidenced as such, for all the money, securities or property received from the customer or accruing to the customer pursuant to paragraph (a),

Lloyd's Rep 224, *E. Bailey & Co. Ltd v. Balholm Securities Ltd* [1973] 2 Lloyd's Rep 404. Also see generally Hains, note 9, *supra*.

[63] See reg. 17, FTR and Rule 914.

[64] See reg. 18, FTR.

[65] See reg. 21(2) and Rule 522.

and shall not commingle that money, security or property with the funds of the futures broker or use them to margin, guarantee or to secure the contracts or extend the credit of any customer or person other than the person for whom they are held."

The provisions relating to the segregation of customers' monies are in place to protect the customer. It extends to all monies received by the broker from a customer and covers monies received in connection with futures transactions as well as customers' funds received for the trading in other financial instruments. Further regulations in the FTR stipulate in detail how customer's accounts are to be maintained and what records of transactions and of particulars of customers are to be kept by futures brokers, as well as the necessity for daily computation.[66] The Rules also have detailed provisions pertaining to the segregation of customer's money.[67]

The FTA defines a "customer" in S. 37(9) and this definition has been adopted by the Rules. A "customer" for the purposes of segregating customers' monies is:

"a person on behalf of whom the futures broker deals, or from whom the futures broker accepts instructions to deal, in futures contracts...but does not include-

[66] See regs. 15, 15A, 15B, 15C and 15D, FTR. Many detailed requirements were enacted after the Barings debacle. Nick Leeson had managed to blur house and customer monies. In para 13.19 of the Ministry of Finance's *Report*, it was stated: "Because of Mr Leeson's failure to properly distinguish and report house and client margins...the extent to which the large exposure limits had been exceeded by the Barings Group was not accurately relected in the large exposures reports submitted by the Baring Group."

[67] See Rule 917.

(a) the futures broker itself with respect to dealings for the proprietary account of the futures broker;

(b) a director, officer, employee or futures broker's representative of the futures broker; or

(c) a related corporation[68] of the futures broker with respect to instructions accepted to deal for an account belonging to and wholly for the benefit of that related corporation."

The segregation provisions safeguard the customer's interests in two ways. First, the detailed administrative provisions relating to the maintenance of customers' accounts make it more difficult for brokers to indulge in the misapplication of customers' funds. Second, the customers' monies are not to be made available for the payment of the debts and liabilities of the broker.[69]

Directors, officers, employees, futures broker's representatives are not so protected. Insofar as a related corporation is concerned, it is anomalous that related corporations dealing for an account belonging to and wholly for the benefit of itself are not customers to be protected by segregation provisions whereas related corporations dealing for an account belonging to and wholly for other related corporations (and perhaps even including itself) would be customers worth

[68] S. 2 of the FTA defines "related corporation as having the same meaning as in the Companies Act. A "related corporation" as defined in the Companies is a corporation that is either the holding company or the subsidiary of another corporation, or a subsidiary of the holding company of another corporation. See s. 4 and s. 6, Companies Act. See also s. 5 of the Companies Act for the definition of "subsidiary" and "holding company."

[69] See s. 37(6), FTA which states that: "Money, securities or property received from a customer and held by a futures broker in a separate trust account under subsection (1) shall not be available for payment of the debts of the futures broker to a creditor of the futures broker...unless the creditor is a customer of the futures broker and the debt owed to the creditor was incurred directly in connection with trading in futures contracts...carried out on behalf of that customer."

protection. It is submitted that the latter related corporations deserve less protection that directors, officers, employees and representatives.

Risk Disclosure Statement

S. 39(1) of the FTA provides that:

> "No futures broker shall open a futures trading account...for a customer unless he furnishes the customer with a separate written risk disclosure document which shall be in such form and manner as may be prescribed by the Authority, and receives from the customer an acknowledgment signed and dated by the customer that he has received and understood the nature and contents of the disclosure document."[70]

The form of the requisite risk disclosure document is found in the FTR.[71] At the SIMEX level, it is provided in Rule 913 that a member may not open an account for a customer unless the member first provides to the customer a separate written disclosure document prescribed by the exchange and receives from such customer a signed and dated acknowledgment that such customer received and understood the disclosure document. Rule 913 effectively tracks the words of s. 39(1). Whereas breach of Rule 913 results in a minor offence, breach of s. 39(1)

[70] There are similar provisions for risk disclosure documents to be delivered by futures pool operators, see s. 39(2), FTA, and by futures trading advisers, see s. 39(3), FTA.
[71] See Form 11 of the FTR as amended by the Futures Trading (Amendment) Regulations 1996, S81/96, which came into effect on 16 February 1996.

leads to the commission of an offence, liable on conviction to a fine or imprisonment.[72]

The extent of the statutory duty is to furnish a risk disclosure statement and then to receive an acknowledgment signed and dated by the customer that he has received and understood the nature and contents of the disclosure document. There is no requirement for the broker to assure himself that the customer has indeed understood the nature and contents.

The question is whether the broker has a greater fiduciary duty to explain the contents of the risk disclosure document, in particular, to a customer who is unfamiliar with futures trading. One case seems to suggest that the broker owes such a duty. In *Rest-Ezi Furniture Pty Ltd v. Ace Shohin*,[73] representatives of the defendant company importuned the plaintiff company who had no prior experience in commodities futures to invest in red beans on the Tokyo Commodity Futures Exchange. The plaintiff represented by its managing director was given some contract documents which contained reference to "margins." Although he said he did not understand various terms, he signed the documents. A few days after signing, the market dropped and the plaintiff was asked to pay a substantial margin call, which it did pay amidst protests to the defendant for not having been informed about margin calls. More margin calls were made and the plaintiff refused to pay, and instead sold a portion of its contracts at a loss. The plaintiff then sued the

[72] S. 40 of the FTA provides that failing to comply with s. 39 would result in an offence, liable on conviction to a fine not exceeding $30,000 or imprisonment for a term not exceeding 3 years or both.

[73] Unreported, 25 September 1986, Yeldham J, Supreme Court of New South Wales. The facts are obtained from a commentary by Frohlich, "Recent Cases" (1987) 61 ALJ 192.

Although the decision in *Rest-Ezi Furniture* has been criticized,[77] a case of a broker failing to explain the risk disclosure document to a customer who obviously is incapable of understanding an English document would pose a problem. For one who understands English, the wording of the statement in relation to "margin" prescribed by the FTR is clear and simply drafted.[78] The case for the broker is worsened, where the broker has actively solicited or importuned the customer.

Before ending the discussion on the risk disclosure requirement, it is worthwhile reflecting upon the effects of a breach of the statutory obligation on the part of the broker to furnish a risk disclosure statement to a customer. Could a failure to provide a risk disclosure statement or receive an acknowledgment be used as an effective illegality defence on the part of the customer? *Tan Chor Thing*[79] made it clear that a contract entered into with a broker who had breached the requirements of the FTA could be illegal and unenforceable. This is particularly so when the customer is not *in pari delicto* and did not know of the futures broker's infringement of the FTA. This would weed out savvy customers who are merely relying on a technical defence to defeat a broker's claims. As far as the genuinely prejudiced ignoramus is concerned, the mandatory risk disclosure

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[77] The dismissal of the application of an exclusion clause, the failure to to place emphasis on a written contract and the significance of the fact that the plaintiff had paid to the defendant two margin calls, arguable affirming the contract, had been highlighted by Frohlich, note 73, *supra*.
[78] See Form 12, Second Schedule, FTR for the "Risk Disclosure Statement Required to be Furnished by a Futures Broker" which states at clause 2(a): "If the market moves against your position or margin levels are increased, you may be called upon to pay substantial additional funds on short notice in order to maintain your position. If you fail to comply with a request for additional funds within the time prescribed, your position may be liquidated at a loss and you will be liable for any resulting deficit in your account."
[79] See Chapter 5, note 73, *supra*.

requirements are there to protect him and it would be against policy to allow the broker to claim upon such a contract.

CHAPTER 7

CONCLUSION

In a thorough discussion on futures trading, the problem of futures market fraud and other malpractices ought to be discussed. However, this is but an introduction and due to various practical reasons, such futures frauds, malpractices and the criminal sanctions which they attract will not be discussed. Suffice it to say that in this area of governing the futures market, questions of policing, detection, enforcement and the imposition of effective penalties abound.

Indeed, it is odd to leave this topic for the last as the body of futures law and regulation that has been built up had as its underpinnings legislation and regulation designed to deal with the issue of fraud and malpractice and the maintenance of a fair market, or level playing field. The absence of this topic from this introductory text can only be justified on the grounds that it deserves separate and exclusive attention. The issues arising in policing futures malpractice are complex. The entire juridical basis of criminalizing certain financial markets abuses is uncertain. What are the paramount considerations? The protection of the underdog consumer, the protection of whole societal economic well-being, the protection of the basic morals of a level playing field?

For various reasons, authorities have to guard against abuses and malpractices not amounting to criminal fraud, in particular, price manipulation, insider dealing and excessive speculation. A futures exchange witnesses the daily turnover of a large amount of money and the easy opportunities of making a large amount of money. As the apostle Paul continues to warn us: "For the love of money is a root of all kinds of evil. Some people, eager for money, have wandered from the faith and pierced themselves with many griefs."[1]

The sophistication of the unscrupulous is evergrowing and herein lies the urgency behind global cooperation in regulatory efforts. The Barings episode has highlighted the importance of international cooperation in the policing of financial futures markets which are inextricably linked to one another in an international financial network. Developments in technology have drawn international markets closer to one another. Many players in the market are institutions with a presence in several jurisdictions. Furthermore, even if a player is based in one jurisdiction, due to advances in telecommunications and computer technology, it is common to trade on various international exchanges. In this environment, it is not enough for regulators in one jurisdiction to monitor the positions of their exchange members and their customers only in one jurisdiction. What happens in another jurisdiction may have tremendous consequences. Wrote the Inspectors in their *Report*:

> "This episode reflects the need for greater co-ordination between the regulatory authorities of different jurisdictions; in this case, between London and Singapore. There is also a need for close monitoring of financial institutions with cross border operations."[2]

[1] 1 Timothy 6:10, New International Version
[2] Para. 15.43, Ministry of Finance's *Report*.

SIMEX has appeared to commit itself to greater global cooperation. One year after the Barings episode, in March 1996, SIMEX signed an International Information Sharing Agreement and Memorandum of Understanding[3] with more than 45 other exchanges and clearing houses for futures and options located in the Asia-Pacific region, the US, Europe and Africa. The agreement is aimed at enabling exchanges and clearing houses to share information about their common and related members. The agreement is unprecedented in the number of organizations and jurisdictions participating and in its scope, covering both market and financial surveillance issues.

This international agreement was the work of a Global Task Force on Financial Integrity established by the Futures Industry Association in March 1995 as a result of the Barings crisis. In its short history, the agreement has already been successfully invoked by the US during the Sumitomo copper crisis which erupted in mid-1995.[4] The adequate and complete governance of a local market comprised of international players requires a concerted global regulatory effort. This is most true in the case of SIMEX where international institutional investors, make up 83 per cent of its business.[5]

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[3] At the Futures Industry Associations' International Futures Industry Conference at Boca Raton Resort & Club, Boca Raton, Florida US on 15 March 1996. See SIMEX press release dated 14 March 1996.

[4] See the talking points of CFTC Commissioner John E. Tull at the Futures and Options Market Regulators Meeting held in Burgenstock, Switzerland on 5 September 1996.

[5] See Rama Pillai, Vice President Business Development Development Department, SIMEX, "Singapore--Market Commentary: Futures," *The Capital guide to Financial Futures and Traded Options in Asia*, ISI Publications at 201. SIMEX prides itself as an institution-driven market, with the majority of users being international banks, corporate treasurers, money, portfolio and pension fund managers and a large number of commodity trading advisers. However, as illustrated by the Barings episode, what's in a name?

Jerry W. Markham, *Commodities Regulation: Fraud, Manipulation & Other Claims*, 1996, Clark Boardman Callaghan

Helen Parry, Eric Bettelheim & William Rees, *Futures Trading Law and Regulation*, 1993, Longman

Manfred E. Street, ed., *Futures Markets*, 1983, European University Institute, Basil Blackwell

UK Law Commission (No. 236), *Fiduciary Duties and Regulatory Rules*, 1995

Peter G Zhang, *Barings Bankruptcy and Financial Derivatives*, 1995, World Scientific

The Capital Guide to Financial Futures and Traded Options in Asia, ISI Publications, 1996

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Commodity Futures Law Reporter, Commerce Clearing House, Inc.