



**The Hon David Bradbury MP**  
**Parliamentary Secretary to the Treasurer**

18 November 2010

Ms Joanne Rees  
Convenor  
Corporations and Markets Advisory Committee  
GPO Box 3967  
SYDNEY NSW 2001

[Extract from the letter]

**The definition of derivatives**

Subsection 761D(1) of the Corporations Act, in conjunction with the *Corporations Regulations 2001* (the Corporations Regulations), defines a derivative as an arrangement where:

- a party must or may be required to provide consideration at some future time;
- that future time is not less than three business days for foreign exchange contracts and one business day for all other arrangements; and
- the amount of consideration or the value of the arrangement is determined by reference to something else.

The Corporations Regulations also modify the ‘future time’ requirement in the Corporations Act and state that even if the consideration is required in less than one day, it will still be a derivative.

The Corporations Act goes on to say that certain arrangements are excluded, such as the obligation to buy or sell tangible property. In essence it means that any contract to sell intangible property, whether for shares or debts, or whether for things not traditionally considered to be financial products (for example, intellectual property, royalties and statutory licences) will be a contract for a derivative for the purposes of the legislation.

Many derivative market participants regard physically settled forward contracts over shares as derivatives, primarily because the value of the forward contract varies by reference to the value of the shares, even though the price of the contract does not alter.

- For example, a person could enter into a contract to purchase 1000 shares at \$10 each to be physically settled in a week’s time. Before delivery, the value of the shares could increase to \$15 and the purchaser could sell the contract back to the issuer or a third party at a profit. The value of the contract, therefore, varies by reference to both the share price and the time value of money as reflected in the prevailing interest rate.

Under the present law, this contract is a derivative, since its value varied by reference to the value of the shares, as well as to the time value of money.

Treasury was considering an amendment to clarify the law, however, following targeted consultation, Treasury encountered concern that the amendment could have unintended consequences. The proposed amendment would have stated that an arrangement is not a derivative for the purposes of the Corporations Act if the arrangement would not be covered by the definition but for the fact that the value of the arrangement is ultimately determined by reference to the time value of money. However, stakeholders were concerned that the amendment might exclude physically settled forward contracts from the definition and add complexity to a highly technical area of the law. Treasury also encountered significant confusion surrounding section 761D generally and the implication that there may be significant non-compliance with the current legal requirements.

The lack of clarity as to what changes are required, coupled with confusion among industry participants, suggest that a wider review is required.

CAMAC was closely involved in the original development of the section (the definition of derivative in the Corporations Act is a result of a Companies and Securities Advisory Committee Report in June 1997: CASAC was the predecessor to CAMAC) and has the technical skills and knowledge required to appreciate both the legal meaning of the section and the ways in which it is currently applied and to assess possible ways of revising the definition.

I request that CAMAC:

- examine the definition of a derivative;
- examine the way in which such a definition may be changed to clarify the position of physically settled forward contracts; and
- suggest options to decrease complexity in this area of the law.

It would be very much appreciated if the Committee reported by 30 September 2011.