OFF-MARKET FUTURES FRAUD

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INTRODUCTION

The main form of off-market fraud in the futures industry is bucketing and bucketing is the main focus of this paper. Bucketing is the failure to execute orders on a futures exchange when instructed to do so by a client. On-market fraud actually occurs when trades are executed on-market but abuses occur, for example from running and churning. Preliminary analysis of the policy underlying the *Futures Industry Code* ("the Code") will be given as well as the background to the introduction to the Code (and Chapter 8 of the *Corporations Act*).

The 1970s saw the birth of financial futures in the United States and closely followed by their introduction in Australia. The advent of financial futures marked a tremendous growth period for the futures industry world-wide.[1] 1980 saw the Sydney Futures Exchange (SFE) introduce the first futures contracts to incorporate cash settlement. The SFE also introduced the same year the first financial futures options. However, prior to the introduction of the first cash settled futures contract there were concerns as to whether such a contract would be void as a contract of gaming and waging. To overcome any possible argument the SFE approached the NSW Government and requested that legislation be enacted to provide the futures contracts traded on the SFE were not void by virtue of Section 16 of the *Gaming and Betting Act*.

The Government subsequently enacted the *Futures Market Act* 1979. The Government also took the opportunity to introduce a relatively limited form of Government supervision of the futures industry. The main features of the Act were:

(i) to ensure cash settled futures contracts trading on the SFE were not void by virtue of s16 on the *Gaming and Betting Act*; and

(ii) any amendments to the Business Rules of the SFE required the approval of the Consumer Affairs Commission.[2]

The main policy consideration underlying the *Futures Markets Act* was the gambling and betting question and not the regulation of the futures industry per se.

Neither prior to the *Futures Market Act* nor after the Act was it necessary to be licensed in or to deal in futures contracts, nor be a member of the SFE. As noted, the mounting collapses (primarily of non-members of the SFE) around the time of the gold boom in the early 1980s prompted the Exchange to press for a comprehensive national scheme to regulate futures. It was also important for the emerging industry to achieve

1 See generally Calder, Lindsay and Koch, *Futures Stock* (revised edn, 1986).
2 *Futures Market Act* 1979 s4.

recognition overseas and the passing of a comprehensive Act would assist that objective. The need for national legislation was also recognised by the Campbell Committee's Report on the Australian Financial System.

During the mid 1980s the development of fraud can be divided into two broad categories. First, those individuals or companies who offer so-called "leverage currency contracts" to members of the public.[3] Secondly, those individuals or companies who purport to be futures brokers, but instead of executing the orders on a recognised futures exchange, bucket them. That is, the orders are not placed on the market.[4] These bucketshops usually traded such exotic commodities as Tokyo Red Beans and Maebashi Dry Cocoons.

The leverage currency dealers do not, as a general rule, represent that they trade on a recognised futures exchange. It was, however, normal practice for them to take a principal position against their clients. This meant that a loss to the client was an equivalent profit to the company, and conversely a profit to the client was equivalent loss to the company. Therefore, it is in the company's interest to let losses mount and "close out"[5] the client's contracts while in a loss situation. Profitable contracts are "rolled-over"[6] into new contracts with the hope that a loss would result. Excessive commissions are analogous to a bookmaking operation where the clients have a bet with the company on the movement of various currencies or other commodities. The demise of the leverage currency dealers was brought about by decisive action taken by the NSW Corporate Affairs Commission (CAC) under the *Futures Industry (NSW) Code*, and the *Companies (NSW) Code.*[7]

The second major group are those companies or individuals who purport to execute orders on recognised futures exchanges, but in fact the orders are never placed but rather they are bucketed (of course, not all companies who trade Japanese markets bucket). It is important to appreciate that bucketing is used in a narrower sense in this paper. Bucketing is sometimes said to occur where a broker takes a principal position against a client with the client's knowledge. Bucketing is used here to mean the situation where the broker represents to the client that trading is occurring on a recognised exchange but it is not.

3 The term "leverage currency contract" is used in a generic sense here, and the contracts have been known by a variety of other names.

4 Bucketing is discussed later in the chapter.

5 "Closing out" means entering into an equal and opposite contract. The difference in price between the contracts will determine whether a profit or loss has been made.

6 Profits are realised by closing out the client's position. The profits are then used to re-establish a position in the market, hence the client's position is "rolled-over".

7 See Lampe, A, "Corporate Crime: A New Growth Industry?" and Hains, M G, "Bucketshop Busters". Both papers were delivered in September 1987 at the Institute of Criminology (University of Sydney) seminar on Policing Corporate Crime, see (1987) 74 *Proceedings of the Institute of Criminology* 40 and 65.

POLICY OF CODE AND ACT

In *Shoreline Currencies (Australia) Pty Limited v Corporate Affairs Commission of NSW* [8] one of the questions considered was the definition of futures contract. Three important principles of general application can be extracted from the judgment of Lee J in *Shoreline Currencies*. Firstly, the words used in the definition will be given their natural meaning and not be unduly restricted in the scope of their operation.[9] Secondly, (a corollary of the first), effect will be given to the policy of the Code.[10] Thirdly, when determining whether a particular instrument falls within the definition a court will look to the form and the *substance* of the instrument.[11] This is implicit from the treatment of the definition of "adjustment agreement" by Lee J (a sub-definition of the definition of futures contract). In principle the same can be said of the definition of futures contract in the Act.

Consideration should be given to the policy underlying the Code (and the Act) and how that will (or should) influence the construction of the Code and Act. The policy of the Code, as stated in the Explanatory Memorandum, is to regulate the futures industry in the States and Territories of Australia,[12] in particular, the regulation of the manner in which certain non-members of the Sydney Futures Exchange promoted and conducted their business.[13]

A fundamental objective of the Code and Chapter 8 of the Act (the futures chapter) is to protect the interests of clients. This is clearly evident as six of the ten parts of the Code deal with the provision of safeguards for clients (for example, licensing participants in the industry; establishment of a fidelity fund, offence provisions, etc).[14]

The Code and Chapter 8 of the Act will only regulate instruments which are "futures contracts". Accordingly, this definition is the "corner stone" of the Code (and Chapter 8 of the Act). The Code seeks to safeguard the interests of the public by:

(i) requiring the licensing of futures brokers and advisors;[15]

8 (1986) 10 ACLR 847, 4 ACLC 686.

9 (1986) 10 ACLR 847 at 855, 4 ACLC 686 at 694.

10 (1986) 10 ACLR 847 at 857-8, 4 ACLC 686 at 697.

11 (1986) 10 ACLR 847 at 857-8, 4 ACLC 686 at 697.

12 *Futures Industry Act* (Cth) s3.

13 Attorney General's Explanatory Memorandum on the Futures Industry Bill 1986 at 16.

14 The first substantive background paper trading in Australia was prepared by the New South Wales Corporate Affairs Commission on 7 June 1982. The paper was entitled "The Futures Market in Australia: Possible National Regulation Paper for Ministerial Council", see in particular pages 32-34. See also Spender J's comments during the second reading of the Futures Industry Bill in the House of Representatives, 29 April 1986 *Hansard* at 2666. Rutledge D J S, "Overview of the National Futures Legislation", BR&S International Conference March 1986 at 2: Nottle R W, "Overview of the National Futures Legislation — NCSC Commentary", BR&S International Conference March 1986 at 1; a second paper of the same name was delivered by Dickens MF, see page 1.

15 Section 61 of the Code requires futures brokers to be licensed (s1142 of the Act). Section 63 of the Code requires futures advisors to be licensed (s143 of the Act). Practice Note 333 issued by the NCSC discusses the tests to be applied in determining whether a futures brokers or advisors licence is required. For a detailed discussion of sections 61 and 63 see Hains, M G, "Licensing Implications of the Futures Industry Code" (1987) 3 *Aust Bar Rev* 216.

(ii) requiring licence holders to take responsibility for the acts of representatives;[16]

(iii) requiring futures brokers to disclose the risks of trading to clients prior to trading on their behalf;[17]

(iv) requiring the establishment of a fidelity fund to compensate clients who have suffered loss as a result of a "defalcation or fraudulent misuse of money" by a member of a futures exchange or futures association;[18]

(v) providing a statutory framework to facilitate co-regulation of the futures industry by self-regulatory organisations and the NCSC; and

(vi) prohibit certain forms of abusive behaviour, for example, bucketing and churning.[19]

Having regard to the above, the definition had to be sufficiently wide so that protection could be afforded to the public — in other words, not permit the definition to be easily avoided. Coupled with this was the need for flexibility in order to accommodate the possibility of change.

On the other hand the definition should not regulate instruments which were clearly not intended to be regulated, for example, certain FRAs and swaps [20] offered by banks in the interbank market. The balance was struck by defining the concept of a futures contract in wide terms [21] and then employing devices to reduce the definitions impact on FRAs and swaps. The devices were, firstly, the concept of standardisation, and secondly, the exclusionary part of the definition. It is necessary, therefore, to understand the structure of the definition of futures contract (this will be considered under the next heading). But firstly, why regulate futures contracts and not other forms of forward

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16 The *Co-operative Scheme Legislation Amendment Act* 1989 requires futures brokers and futures advisors to give each representative a "Proper Authority". The *Co-operative Scheme Legislation Amendment Act* then makes the Principal liable for the acts of its representative. For a discussion of the implications of the *Co-operative Scheme Legislation Amendment Act* see Haintz, L, "Amendments to the Licensing Provisions of the Securities Industry Code and the Futures Industry Code" *Butterworths Company Law Bulletin* No 17 of 1989 paragraph [263]. The Sydney Futures Exchange requires client advisors to be Registered Representatives of its members. A Registered Representative is normally required to sit and pass an examination. See also Practice Notes 19, 20 and 21 issued by the Sydney Futures Exchange and Practice Note 333 issued by the NCSC.

17 Section 87 of the Code (section 1210 of the Act). For a pro-forma example of a section 87 document see Practice Note 10 issued by the Sydney Futures Exchange.

18 Part VII of the Code (Part 8.6 of the Act).

19 Bucketing is the failure of a broker to execute trades on a recognised futures exchange when instructed to do so by a client. The main provision prohibiting bucketing is section 128 (s1258 of the Act). For a discussion of bucketing see Hains, above n7 at 65. Churning is the excessive trading of an account by a broker for the purpose of generating commission without regard to the needs and objectives of the client. For a discussion of churning see Hains, M G, "Churning and Burning: A Futures Cause of Action?" (1989) 63 *ALJ* 608.

20 Nottle, R W, "Overview of the National Futures Legislation — NCSC Commentary", BR&S at 5. At that time, Mr Nottle was the Senior Director of Operations at the NCSC. Mr Nottle is now Deputy Chairman of the Hong Kong Securities and Futures Commission.

21 A number of provisions in the Code have the purpose of widening the scope of the definition of futures contract (directly or through sub-definitions) to reduce avoidance. See for example ss4(2), (3), (7), (8), 5 and 6.

agreements? The characteristics of a futures contract include the following: firstly, futures markets can be extremely volatile.[22] Secondly, this volatility is "enhanced" by the leverage which a futures contract offers.[23] Thirdly, futures contracts are fungible and can be used as a trading vehicle.[24] The ability to trade can expose a client to greater risk. Fourthly, futures contracts are accessible to retail clients. Retail clients may not have the resources (whether financial or otherwise) to sufficiently protect their own interests.

FRAs and swaps exhibit a number of characteristics similar to that of futures contracts. The third and fourth points made in the preceding paragraph are, it is submitted, important in deciding for the purposes of regulation why a given instrument should or should not be a futures contract within the meaning of the Code or the Act. It is these features which particularly expose clients to risk. This is not to suggest that other factors are not important.

THE DEFINITION OF FUTURES CONTRACT IN THE CODE

The definition of futures contract in the Code is made up of four separate parts. Firstly, futures contract is defined to include an "eligible commodity agreement". Broadly speaking an eligible commodity agreement is a deliverable futures contract, which is a futures contract under which physical delivery of the subject matter of the contract is possible (delivery is compulsory if the contract is held until the settlement day). Secondly, futures contract is defined to include an "adjustment agreement". Broadly speaking an adjustment agreement is a cash settled futures contract, which is a futures contract under which physical delivery of the subject of the contract is not permitted. The difference between the price paid upon opening the contract and the settlement price is paid in cash on the settlement day. Thirdly, futures contract is defined to include a "futures option" which is an option or right to assume over an eligible commodity agreement or an adjustment agreement. In other words, it is an option over what are commonly referred to as futures contracts. Fourthly, futures contract is defined to include a prescribed exchange traded option (or PETO), which is an option over a prescribed index or commodity which is traded on a futures market of a futures exchange. The Act defines futures contracts in very similar terms to the Code.[25]

22 Griffiths LJ in *Merrill Lynch Futures Inc v York House Trading Limited*, said it was well-known that commodity markets were extremely volatile and even experienced people lost money, *The Times*, 24 May 1984 at 15 (Cumming-Bruce LJ agreeing). See also the comments of Moccatta J in *Stafford v Conti Commodity Services Ltd* [1981] 1 All ER 691 at 697.

23 Loosely speaking leverage is where an amount of money smaller than the face value of an instrument is used to control that instrument. For example, a futures contract is said to have leverage because the deposit (also known as the initial margin) is a sum substantially less than the face value of the instrument underlying the futures contract.

24 Submission to the Trade Practices Commission by the Sydney Futures Exchange dated 30 September 1985 at 8. See also Spender J's comments during the second reading of the Futures Industry Bill in the House of Representatives, 29 April 1986 *Hansard* at 2664-5.

25 For a discussion of the nature of a futures contract from a commercial (*not* legal) viewpoint, see Bruce, R, McKern, B, Pollard, I and Skully, M, *Handbook of Australian Corporate Finance* (3rd edn, 1989) at 430. The Code and the Act attempt to define the concept of futures contract in detailed terms. Not all jurisdictions have adopted this approach. For example under the *Financial Services Act* 1986 (UK) three sub-definitions of "investments and investment business" would be relevant to the Australian

An instrument will *not* be a futures contract:

(i) if it is an agreement (not a *standardised* agreement);

(ii) that is,

(a) a currency swap;

(b) an interest rate swap;

(c) a forward exchange rate contract; or

(d) a forward interest rate contract, and

(iii) if a bank or merchant bank is a party to it.

The exclusionary part of the definition is important but is not the subject of this chapter.[26]

BUCKETSHOPS

What is Bucketing

Bucketing is the failure to execute an order on a recognised futures exchange when required to do so. Bucketing involves a broker not complying with a client's instruction to execute a contract on a recognised futures exchange.[27]

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concept of a "futures contract". They are "futures", "options" and "contracts for differences" (Part 1 of Schedule 1). The definition of "futures" is designed to catch deliverable futures contracts. "Contracts for differences" would include, inter alia, cash settled contracts. The definition of option would include, inter alia, options over "futures" and "contracts for differences". In Japan there is a definition of futures contracts which to some extent is based on the definition in the Code. In Japan, a security dealer cannot engage in banking activities and vice versa. When plans were developed to introduce financial futures in Japan there was competition between the securities houses and the banks as to who would control the new market. The Japan Federation of Bankers' Associations drafted and submitted proposed articles of association to the Japanese Diet. It was necessary to draft a definition of futures contract and distinguish them from the business carried on by securities houses. As part of that process the Federation looked at the definition of futures contract in the Code.

26 This article does not consider whether options can be "adjustment agreements" or "eligible commodity agreements". For a detailed discussion of whether over-the-counter options are futures contracts see Hains, M G, "Are OTC Options Futures Contracts?" (unpublished paper, December 1988). The article considers the definition of futures contract in the Code in great detail and in particular considers whether OTC opinions can be eligible commodity agreements or adjustment agreements. The author expresses the view that OTC options cannot be eligible commodity agreements or adjustment agreements. The author also expresses the view that the decisions in *Carragreen Currency Corporation Pty Ltd v CAC(NSW)* (1987) 7 NSWLR 705; 11 ACLR 298; 5 ACLC 148; *CAC(NSW) v Romy & Brother Holdings Pty Ltd* (1987) 12 ACLR 289; 5 ACLC 901; *CAC(NSW) v Lombard Nash International Pty Ltd (No 1)* (1987) 11 ACLR 566, 6 ACLC 269, and *CAC(NSW) v Lombard Nash International Pty Ltd (No 2)* (1987) 9 NSWLR 497; 11 ACLR 866; 5 ACLC 651 are incorrect on a number of major matters concerning the definition of futures contract. It is also arguable that the exclusionary part of the definition does not apply to options over the various instruments described. So the exemption may not apply to a swaption for example (a swaption is an option over a swap). This may lead to a situation where a swaption is regulated but once exercised the resulting instrument is not. Another difficulty is to determine the meaning of "swap". For example does the concept of a currency swap only mean a cross-currency fixed-to-fixed swap or can it include a cross-currency fixed-to-floating swap; a same currency floating-to-floating swap and a cross-currency floating-to-floating swap?

Bucketing is prohibited by section 128 of the *Futures Industry Code* which provides:

> A futures broker shall not deal in futures contracts on behalf of another person unless the dealing is effected:
>
> (a) on a futures market of a futures exchange or recognised futures exchange;
>
> (b) on an exempt futures market; or
>
> (c) as permitted by the business rules of a relevant organisation of which the broker is a member.
>
> Penalty: $10,000 or imprisonment for 2 years, or both.

The effect of section 128 is to compel all trades to be executed on a futures market, unless otherwise permitted by the business rules of an exchange. Section 128 is the principal anti-bucketing provision of the Code. For the purposes of section 128 a "futures exchange" meant the Sydney Futures Exchange or the Australian Financial Futures Market (AFFM). "Recognised Futures Exchanges" were listed in Schedule 1 to the *Futures Industry Regulations*.

Section 45 of the Code will also be relevant as it prohibits the establishment, maintenance or provision of a futures market that is neither a futures market of a futures exchange nor an exempt futures market. This section prohibits a broker taking a principal position against a client. When a broker does take a principal position against a client in an off-exchange situation the opportunity for abuse is obvious.

Types of Bucketing

Bucketing is sometimes used to refer to where a broker takes a principal position against a client with the client's knowledge. Bucketing is not being used in that sense here.

There are two main types of fraudulent bucketing. Firstly, a broker does not place any orders on exchange. In other words all orders are bucketed. This has been the type of operation prevalent in Australia. Secondly, some of the orders are placed, but the majority are not (a "partial bucket"). This type of operation has a number of advantages over the first type of bucketing. Firstly, there is an audit trail in respect of some trades. Secondly, this type of operation is harder to detect and the evidentiary problems of proving bucketing are greater.

When a broker is partially bucketing it may purport to place orders on behalf of ten clients on a given day. However only a small percentage of the trades are placed on the

27 A broker is obliged to follow a client's instructions, see Hains, M G, "Duties and Obligations of a Futures broker to His Client" (1987) 3 *Aust Bar Review* 122 at 125 and 129. See also *Drexel Burnham Lambert International NV v Nasr* [1986] 1 FTLR 1 at 12; *Options Investments (Aust) Pty Limited v Martin* [1981] VR 138 at 142; *Commodities Exchange Act* 1974 s46(D); and *Re Siegel Trading Company Inc* [1977-1980 Transfer Binder] Comm Fut L Rep (CCH) II 20,452 at 21,827 (1977). For a judicial discussion of bucketing see *CAC (Vic) v Shintoh Shohin Pty Ltd and Others* (1988) 6 ACLC 8; (1987) Aust Sec Law Cases 76-134; *Southern Cross Commodities Pty Ltd (In Liq) v Ewing* (1989) 14 ACLR 39 at 45 and 68. The author disagrees with a number of the comments in the *Southern Cross Commodities* cases, for example, that failing to execute orders on a futures exchange, without the client's knowledge, is not fraud.

market; the broker takes a principal position against the client on the balance of trades. It is important, for the rogue broker, to ensure that the number of trades placed on-market is greater or equal to the largest single order placed by a client on a given day. When requested by a given client to establish an audit trail the broker is able to. It is only if the broker is asked to establish an audit trail for all orders on a given day that the fraud will be discovered. It will become apparent from subsequent discussion that this type of operation is difficult to detect.

Why is Bucketing Wrong?

There are a number of reasons why bucketing is wrong. Firstly, by the broker taking a principal position against a client it creates the ultimate conflict of interest, so a loss to the client is a profit to the broker and a profit to the client is a loss to the broker. Accordingly, the broker lets losses "run" and cuts short profitable trades. The broker is able to do this as it either has actual control (by virtue of the client signing a discretionary client agreement) or de facto control as the client relies heavily on the advice of the broker. Secondly, bids to buy or offers to sell are not done through the open outcry trading system. Therefore the client may not be getting the best available price. Thirdly, by not executing trades on-market the trades are not registered at the Clearing House. Accordingly, the client is deprived of the indirect benefit of the Clearing House's guarantee. The client relies more on the financial integrity of the broker as opposed to the whole market — as would be the case if the trade had been registered. Fourthly, the failure to register the trade may deprive the client of a right to claim against a fidelity fund or guarantee fund concerning the market in question. Fifthly, brokers are in a position of trust — yet at the same time they have a conflict of interest with their client. Sixthly, this type of operation is normally set up from the outset to run on a fraudulent basis.[28]

Why Australia?

A number of factors have assisted the growth of this type of activity in Australia. The factors include:

(i) the deregulation of the Australian financial sector, for example, the lifting of exchange rate controls which allowed brokers to more freely deal on foreign exchanges.[29] The deregulation of the financial sector and its resulting sophistication has encouraged the growth of Sydney as a major financial city in the Pacific Basin, in particular we have seen growth in the use of futures contracts;

(ii) a growing public awareness of futures;

(iii) the greed and gullibility of the Australian investing public;

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28 For a discussion of bucketing prior to the introduction of the Futures Industry Code see Gardiner, P W, "The Legalisation and its Effect on Futures Trading in Australia", BLEC Seminar, 31 January 1985; Magarey, D R, "Questions Surrounding the Enforcement of Futures Contracts", BLEC Seminar, 31 January 1985; Rutledge, D J S, "Is there a Need for Greater Regulation of the Australian Futures Industry and Does the Draft Bill Meet this Need?", BLEC Seminar, 31 January 1985.

29 See generally Calder, Lindsay and Koch, above n1, and Carew and Slatyer, *FOREX: the Techniques of Foreign Exchange* (1989).

(iv) the wealth of Australia;

(v) the absence of national legislation to regulate the futures market in Australia prior to 1 July 1986.

An important factor was that in the early 1980s when the Australian futures market was experiencing tremendous growth this type of fraud was prevalent in Asia. The authorities took steps to curtail the abusive activities of certain companies. Unfortunately, the authorities in Asia laid no charges against the people involved nor did they inform the relevant Australian regulatory authorities. These companies moved into Australia unhindered.

Characteristics of a Bucketshop

Generalisations should, as a rule, be avoided. However, there are certain characteristics which suggest a bucketshop operation. Not all bucketshops will have all characteristics. Similarly, the presence of some of these characteristics does not necessarily mean there is a bucketshop. Characteristics of bucketshops include:

(i) palatial offices where no expense is spared. It was not uncommon to find fancy wall charts plotting the movement of Maebashi Dry Cocoon or some other exotic commodity in the reception area (the charts are usually out of date), and a jar of Tokyo Red Beans may be visible in the plush reception;

(ii) employees are literally taken off the street, their previous experience or personal qualities are of little significance. What little training there is, emphasises salesmanship rather than providing competent advice to clients;

(iii) the client advisors do not know a great deal more about futures than the people they are cold-calling. Staff turnover is generally high;

(iv) client advisors are paid a small retainer and their income is principally derived from commissions. It is common for commissions to be based on the number of trades executed per month. The higher the number of trades per month, the higher the commission per contract traded. The commissions are generally very high;

(v) client advisors are set "quotas" to attain each month and considerable pressure is brought to bear for those quotas to be achieved;

(vi) trades are predominantly "executed" on overseas markets, in particular, the Japanese markets. One reason why the Japanese markets are choses is because prices on Japanese markets do not fluctuate minute by minute, but are set for all contracts traded in a particular session. Hence the trader is able to inform clients that contracts have all been traded at the one session price, whereas in reality they have not. Additionally, the client is less likely to have access to, or be familiar with, market information on Japanese markets nor will they be familiar with the commodities traded. Quite often there will be one or two companies through whom the orders will pass before they "reach" the Japanese floor member. Invariably, the companies will be in different countries and the "audit trail" supporting the executing of orders will be lost;

(vii) bucketshops are unable to substantiate that orders are being executed on a

recognised futures exchange beyond providing telexes. One purpose which the intermediate companies serve is to act as a barrier against investigation, for example, when asked who the orders are being passed onto, they will respond that it is a trade secret;

(viii) bucketshops will not normally deal with floor members of Japanese markets directly because it would be more difficult to bucket. It should be noted that independent documentary evidence is available from Japanese futures markets if trades were in fact executed. For example, a Japanese broker who executes trades on behalf of clients would be obliged by Japanese law to send a trading advice as well as a monthly statement providing details concerning the date and time of execution of the trade, as well as a full description of the contract traded;[30]

(ix) it is standard broking practice to place orders by phone. Confirmation of the orders will generally be made by telex or facsimile at the end of each day. Daily trading advices are issued together with monthly statements at the end of each month. However, bucket-shops will generally place the orders by telex and receive confirmations by telex. There is no evidence that the orders are executed beyond telexes;

(x) clients sign a discretionary account or "authorisation letter" conferring upon the broker a right to trade on behalf of the client at the broker's absolute discretion;

(xi) clients accounts are churned.[31] That is, trades are placed for the purpose of generating commissions for the company rather than in the interests of the client. The company will inform a client that they are trading one contract for the client, when in fact the contract size is double or even quadruple the actual size of the contract traded on the Japanese markets. The use of double and quadruple contract sizes facilitates churning (although it is not an element of churning in its own right);

(xii) even when the accounts are not discretionary, relatively unsophisticated clients are targeted. Invariably the client will follow the advice of the company and its representatives;

(xiii) nearly all of a client's money is committed to the market straightaway. No money is left in reserve to pay for margin calls. The writer has seen cases where hundreds of positions were opened on the first day of trading;[32]

30 See for example Article 3 of the Tokyo Commodities Exchange for Commission Contracts.

31 See Hains, M G, "Churning and Burning: A Futures Cause of Action?" (1989) 63 *ALJ* 608. Churning is also briefly discussed in Chaikin, D A, "Commodity Investment Fraud" (1985) 6 *The Company Lawyer* 261.

32 See for example *Rest-Ezi Furniture Pty Ltd v Ace Shohin (Aust) Pty Ltd* (1987) 5 ACLC 10 where 240 positions in Tokyo Red Beans were "opened" in the first "trade". The report only refers to 60 contracts but Ace Shohin had quadrupled the size of the contract. If any red bean contracts were actually opened it had to be 240 not 60. The Japanese exchanges do not offer a Tokyo Red Bean contract of 320 bales (only 80 bales). Serious doubts must exist as to whether Ace Shohin ever executed orders on-market. For example, Ace Shohin obtained A$48,000.00 from Rest-Ezi as deposit for opening the Red Bean Contracts. At that time the correct deposit was $57,585.17, that is, there was a shortfall of almost

(xiv) bucketshops typically obtain clients by cold-calling through the yellow pages or other forms of client lists. The client advisors emphasise the profits that can be made and rarely dwell on the risks involved;[33]

(xv) the directors of the broker or senior management are the only ones who know what is going on and the employees are generally not told a great deal;

(xvi) a large volume of trading is done in comparison to the initial investment.[34] It is commonplace for accounts to be churned;

(xvii) it is common for back-to-back positions to be taken (that is, a buy and sell position is taken in the same commodity) and this is erroneously described to the client as "a hedge";

(xviii) it is an established principle that when speculating in futures to let profits run and to cut losses. However, in a bucketshop profits are cut short and losses are allowed to run;

(xix) insufficient commission is charged to cover the minimum prescribed commission which Japanese brokers are required by Japanese law to charge;[35]

(xx) insufficient moneys are called by the broker to cover the Initial Margin prescribed by Japanese law;

(xxi) exaggerated claims of profit potential are made by client advisors. Little or no explanation of the risks involved in speculating in futures is provided to clients or the need to pay margin;[36]

(xxii) clients have difficulty in withdrawing moneys. When a client attempts to withdraw money pressure is brought to bear for them to leave the money in;

(xxiii) when clients lose money the client advisor attempts to obtain more money by promising that if a further investment is made all moneys would be recouped;

(xxiv) there is no apparent trading strategy used in the accounts;

(xxv) client advisors often misrepresent that the broker for which they are working is a member of a recognised Exchange, such as the Sydney Futures

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$10,000.00. Ace Shohin charged $120.00 commission on a round turn. A Japanese broker at that time was required by law to charge $124.12. There was also a 42% depreciation in the Australian dollar against the Japanese yen from 2 January 1985 to 20 May 1986, yet there was no change in the deposit or commission charged by Ace Shohin.

33 See for example *Rest-Ezi Furniture Pty Ltd v Ace Shohin (Aust) Pty Ltd* (1987) 5 ACLC 10; *Dennison v Ace Shohin (Aust) Pty Ltd* (1987) ATPR 40-605 and *CAC(Vic) v Shintoh Shohin Pty Ltd* and others (1988) 6 ACLC 8.

34 Ibid.

35 Article 97-1 of the Commodity Exchange Act 1950 (Japan) states:
"Article 97
1. A commodity commission merchant shall, with respect to the acceptance of the entrustment of transactions on a commodity market, collect from the customer the brokerage and initial margin as security in accordance with the Entrustment Contract Regulation."

36 *Rest-Ezi Furniture Pty Ltd v Ace Shohin (Aust) Pty Ltd* (1987) (1986) Aust Sec Law Cases 76-111 at 85,144.

Exchange. Client advisors also misrepresent that the broker is a large "international" broker;

(xxvi) the commission and Initial Margin levels do not change over a period of time even though there are fluctuations in the Australian dollar;

(xxvii) the broker calls commission and Initial Margins in Australian currency. They were not called in the currency denomination of the contract, that is yen for a Japanese contract. On the SFE contracts linked with COMEX (USA) and LIFFE (UK) were not called in Australian dollars. Rather they are called in the currency denomination of the particular futures contract.

(xxviii) the broker extends credit to clients; and

(xxix) the broker does not rigidly enforce margin calls against clients as required by the business rules of the SFE. Often after an objection is made by a client concerning the margin call, the company will waive it and say it is not necessary for the time being.

If a client complains about losing money, the company will say that 85 per cent of people who trade futures lose money. What they fail to tell the clients is that 99 per cent of their clients lose money. The statement that 85 per cent of people lose money is misleading. *The survey referred to indicated that 85 per cent of unsophisticated speculators lost money.*

Why Were They Allowed to Flourish for So Long?

There is no single factor which permitted the activities to exist for so long, but rather a combination of a number of different factors:

(i) the absence of national legislation permitted these companies to exist in a "void", that is, they could trade without being a member of an exchange or being licensed by a regulatory body;

(ii) clients did not fully understand futures, never mind the elaborate ploys being used. This is particularly important because this resulted in few, if any, complaints being made to the CAC. If a complaint was made to the SFE no action could be taken because they were invariably not members of the SFE and hence the SFE had no jurisdiction to investigate the complaint. Additionally, clients were reluctant to complain to anybody because they are embarrassed.

(iii) even if a complaint was made to Corporate Affairs, the Commission lacked the expertise to investigate the elaborate ploys being used. Both the CAC and the Exchange initially lacked knowledge about the Japanese markets and this hindered any proper investigation;

(iv) the failure to recognise the extent of the fraud in the early stages and allocate sufficient resources to combat the fraud; and

(v) the evidentiary problems of proving fraud. For example, it is difficult to prove that the absence of an audit trail means that the orders were not placed. Additionally, most of the evidence is off-shore.

Why Use Foreign Exchanges?

The reasons for choosing a foreign exchange are simple and include:

(i) where an investor is unlikely to be familiar with such markets;

(ii) language barriers;

(iii) the problem of establishing an audit trail through a number of overseas jurisdictions;

(iv) where evidence is normally overseas and it is costly and resource-intensive to obtain;

(v) difficulty in obtaining the assistance of overseas regulatory authorities;

(vi) the inability to check a broker's trades because there are no official prices published daily; and

(vii) where trading in obscure commodities necessitates more dependence on brokers for advice and other matters such as price, market volatility, market trends and cash market conditions.

Problems Faced by Regulators

The problems faced included:

(i) lack of resources and man power to investigate all the brokers suspected of such behaviour;

(ii) lack of complaints by people who have been ripped off. These people failed to realise that the information they have can give great insight into the company's operation whey they speak to the correct people;

(iii) difficulties in checking foreign qualifications. On occasions, the companies who provided references are of questionable integrity themselves;

(iv) you cannot refuse membership of an exchange or issuing a licence on suspicion. Section 53 of the Code gives an applicant for membership a statutory right of appeal if they are rejected from membership;

(v) the best evidence is usually obtained too late for any effective action to be taken;

(vi) failure of overseas regulatory authorities to assist investigations; and

(vii) the evidentiary problems already discussed.

List of Recognised Futures Exchanges

In Australia a broker is only permitted to execute orders on a "futures exchange" or a "recognised futures exchange". One method of kerbing bucketshops is to remove from the list of recognised futures exchanges those exchanges who fail to render assistance in investigations or whose exchanges are being used to facilitate the fraud.[37] This is not

37 There was never any suggestion that the overseas exchanges where trades were purportedly executed were aware of the fraud.

new; for example, Japan prohibited trading on overseas exchanges due to fraudulent trading by some Japanese companies on overseas markets.

In March 1990 the list of recognised futures exchanges was amended. The list of exchanges was reduced from 54 to 32 despite the addition of at least five new exchanges.[38] The changes fell into two broad categories. First, a number of futures exchanges had merged to form new exchanges. For example, in Great Britain the two new exchanges, as a result of mergers, were the Baltic Futures Exchange (BFE) and the London Futures and Options Exchange (FOX). Secondly, a number of exchanges were deleted from Schedule 1. These were:

(i) Bolsa Brasileira de Futuros (no broker purported to trade on this exchange);

(ii) Bolsa de Mercadorios de Sao Paulo (no broker purported to trade on this exchange);

(iii) Kanmon Commodity Exchange;

(iv) Kobe Grain Exchange;

(v) Kobe Raw Silk Exchange;

(vi) Kobe Rubber Exchange;

(vii) Kuala Lumpur Commodity Exchange;

(viii) Maebashi Dry Cocoon Exchange;

(ix) Nagoya Grain Sugar Exchange;

(x) Nagoya Textile Exchange;

(xi) Osaka Grain Exchange;

(xii) Osaka Sugar Exchange;

(xiii) Osaka Textile Exchange;

(xiv) Tokyo Rubber Exchange;

(xv) Tokyo Sugar Exchange;

(xvi) Toyohashi Dry Cocoon Exchange; and

(xvii) Yokohama Raw Silk Exchange.

No public statement was made at the time of the amendment of Schedule 1 by the NCSC. A striking feature of the deletions is that the exchanges trading the "exotic" commodities have been deleted. In other words, the exchanges which trade futures contracts in which the rogue brokers purported to trade have been deleted. Accordingly, no futures broker can trade on these exchanges. If a broker purports to trade on these exchanges court action can be commenced quickly and effectively for a breach of Section 128 of the Code. At the height of the bucketshops in Australia the writer was working in the Legal and Compliance Department of the SFE and became involved in

38 Marche a Terme International de France (MATIF), Osaka Stock Exchange (OSE), Swiss Options and Financial Futures Exchange (SOFFEX), Tokyo International Futures Exchange (TIFFE) and the Tokyo Stock Exchange (TSE).

investigating this type of fraud. The writer on a number of occasions suggested to the NCSC that the list of recognised exchanges be amended. Deleting exchanges from the list was a relatively quick and effective means of preventing the return of this type of fraud. The amendment is to be commended.

It should be stressed that there has never been any suggestion that the overseas exchanges were involved or even privy to the misconduct by brokers operating in Australia.

Reform

In order to reduce the possibility of a recurrence of market fraud the writer believes the following reforms are required:

(i) Delete those exchanges where rogue brokers purport to trade from Schedule 1 of the *Futures Industry Regulations*. As noted this has been done and will go a long way in preventing this type of fraud.

(ii) Delete from the list of recognised exchanges those jurisdictions which have "blocking statutes". Certain Asian jurisdictions prohibit their nationals or government agencies from giving evidence in criminal prosecutions overseas. For example, at the time of writing Hong Kong will not permit evidence to be given by its nationals or the Securities and Futures Commission in criminal prosecutions in Australia.

(iii) Reverse the onus of proof under section 128 once a threshold level is reached. For example, if the prosecution can establish that an audit trail does exist in relation to a given futures market and no trail exists, then there is a presumption that section 128 is being breached. It would then be incumbent on the defendant to provide a defence as to why no audit trail exists.

CASE STUDY

G H Shin Toh (Australia) Pty Ltd (Shin Toh (Australia)) was a Full Associate Member of the Sydney Futures Exchange. Shin Toh (Australia) is merely one company in a group collectively known as the Shin Toh group of companies. The other companies are: Shintoh Shohin Pty Ltd which operated in Victoria; G H Shin Toh (Adelaide) Pty Ltd which operated in Adelaide; Golden Harvest Investments Pty Ltd which operated in New South Wales. There is a possibility that another company was part of the group, namely Asiavest Corporation Pty Ltd. Asiavest operated in Queensland. The Shin Toh group of companies is also referred to as the Golden Harvest group of companies. The "G H" in G H Shin Toh stands for "Golden Harvest". All companies within the group presently have Receivers and Managers appointed.

Towards the end of 1986 the Corporate Affairs Commission in South Australia took action against G H Shin Toh (Adelaide) Pty Ltd (as well as other futures brokers) in the Supreme Court of South Australia. The Commission sought the appointment of a Receiver and Manager to Shin Toh (Adelaide) on the basis that orders were not being placed on a recognised futures exchange. That is, orders were being "bucketed". The

application to appoint the Receiver and Manager was successful. The Commission also sought to have a Receiver and Manager appointed to the assets of Shin Toh (Australia) located in Adelaide. This application was also successful. Shin Toh (Australia) is incorporated in Victoria. Shin Toh (Australia) futures brokers licence was issued in Victoria. As a result of the action in South Australia and other evidence in the possession of the Victorian Corporate Affairs Commission, action to appoint a Receiver and Manager was commenced in Victoria. The action was commenced in late March to early April 1987. Shin Toh (Australia) defended the action. The matter was set down for hearing later in the year.

The Victorian action was against Shin Toh (Australia) *and* Shintoh Shohin Pty Ltd. The matter went before Mr Justice Nathan of the Victorian Supreme Court, who delivered his judgment on 16 October 1987.[39] The Commission's case revolved around potential breaches of three sections of the Futures Industry Code. They were section 45 (conducting an unauthorised futures market), section 128 (failing to execute orders on a recognised exchange), section 135 (fraud in connection with dealings in futures contracts). The Commission's case had two major thrusts; firstly that Shin Toh (Australia) and Shintoh Shohin were "bucketing" client orders, and secondly, that Shin Toh (Australia) and Shintoh Shohin were churning client accounts.[40] Shin Toh (Australia) and Shintoh Shohin denied both allegations.

For the purpose of considering the judgment, no distinction will be made between Shin Toh (Australia) and Shintoh Shohin. Shin Toh alleged that their Australian operations worked as follows. Orders were solicited by client advisors from clients. The orders were then telexed to Tomataki Boeki, a company which operated principally out of Taiwan. Tomataki Boeki then purported to telex the orders to a company named "Shoji" in Japan. Shoji then purportedly passed the orders on to licensed futures brokers in Japan for execution on the Japanese market.

The Commission alleged that the orders were in fact not being executed, and their offices were merely an elaborate smoke screen for a fraudulent operation. The hearing before Mr Justice Nathan took some seven days at the end of which he concluded in the following terms:

> I am satisfied that, given the climate, given the culture which the defendants [Shin Toh (Australia) and Shintoh Shohin] knew about, they were then able to bucket or, that is, retain the contents of the bucket for their own use.
>
> I do not come, as I have said, to any firm conclusion in relation to bucketing.[41]

The proceedings before Mr Justice Nathan were interlocutory proceedings with the purpose of appointing a Receiver and Manager. Despite commenting that he made no firm conclusions concerning bucketing, it is evident from his judgment that the Commission had substantial evidence indicating that bucketing was occurring. The Judge's comments needed to be guarded because three persons involved in the

39 (1988) 6 ACLC 8 and (1987) Aust Sec Law Cases 76-134.

40 Above n31.

41 (1988) 6 ACLC 10 at 22.

management of Shin Toh had been charged with conspiracy to defraud. The Judge would not want his comments to prejudice their fair trial.

There are a number of factors which the Judge considered important in reaching his conclusions. They were:

(i) Shin Toh permitted client losses to run (that is increase in size), but cut profits short;

(ii) the number of trades purportedly "filled" (that is, executed on the Japanese Futures Market) by Shin Toh were greater than the amount of trades which the Reuters screen indicated had been executed on the market;

(iii) there was no direct communication between Shin Toh and members of the relevant Japanese Exchange;

(iv) there was no independent documentary evidence that trading was being executed on a Japanese Futures Exchange. The Judge accepted that if legitimate trading was occurring such independent documentation could be supplied. The Judge further noted that the explanations of Shin Toh concerning the absence of documentation varied from time to time. The explanations were described by the Judge on occasion as "preposterous";

(v) the Commission structure in Japan is fixed. It was noted that Shin Toh was charging insufficient money to cover that expense;

(vi) on at least one occasion Shin Toh had indicated that a client order had been executed. The trade was going against the client, and the client advisor wished to close out the position. Instead of entering into an equal and opposite trade on the futures market the management simply tore up the original order. This could not have been done had orders been executed on the Japanese Exchange.

(vii) on at least one occasion the Management had given instructions to ensure that a client lost money (the client had asked for the return of his money). The Judge also noted that there was no incentive for client advisors to make money on behalf of clients as the commission structure was based on the number of trades, not profits made;

(viii) the absence of certain important witnesses on behalf of Shin Toh was treaed by the Judge as being confessional behaviour;

(ix) the staff of Shin Toh, at best, received rudimentary training;

(x) Tomatakei Boeki did not acknowledge that orders were received from Slin Toh.

Mr Justice Nathan noted in his judgment that the onus of proof on the Commission was a very high burden of proof. Notwithstanding this, the Judge found that the Commission had discharged its onus.

A number of developments have occurred since the above civil action concluded. Firstly, criminal charges have been laid against the former management of the G H Slin Toh group of companies. The committal hearing of the three individuals concerned took

place in November/December 1988. All three accused were committed to stand trial. At the time of writing the accused are still awaiting trial. Secondly, the Sydney Futures Exchange fined G H Shin Toh (Australia) Pty Ltd $250,000 (the maximum fine) and terminated its membership. Having regard to the penalty imposed it is reasonable to assume that the SFE were of the view that its member was guilty of serious misconduct. It should also be noted that the SFE in May 1988 published notices in daily newspapers around Australia calling for claims against its Fidelity Fund concerning G H Shintoh (Australia) Pty Limited and another company called Nizal Investments Pty Ltd (Receiver and Manager appointed). Nizal Investments' membership has also been terminated. The SFE has made no public statement as to the reasons for the termination of Nizal's membership.

WHAT DOES THE FUTURE HOLD?

No matter how effective a regulatory scheme is, fraud will exist in a futures market in one form or another. This statement does not mean that futures markets are inherently unfair or fraudulent; rather, because of the leverage involved and the money to be made there will always be some undesirable element trying to make "a quick buck".

The futures market in Australia has a good reputation and hopefully that will continue. However, the emphasis on regulation should now shift from "off-market fraud" as discussed in this paper to "on-market fraud" such as front running, insider trading and churning. In the writer's opinion off-market fraud may reappear, firstly because the CAC failed to prosecute a sufficient number of people for criminal offences to deter fraud, and secondly, the existence of blocking statutes in overseas jurisdictions makes it difficult to prosecute people who purport to trade through certain jurisdictions.